5

Reporting Property Sales

Capital gain or loss treatment applies to sales of property held for investment or personal purposes, except for certain items excluded by law from the category of capital assets. Sales of capital assets are reported on Schedule D. On Schedule D, long-term capital gain or loss applies to sales of assets held for more than a year, and short-term capital gain or loss to sales of assets held for one year or less.

Holding period rules are discussed at ¶¶5.13–5.16.

See Chapter 29 for tax-savings opportunities on a sale of a principal residence.

Net long-term capital gains in excess of net short-term losses may receive favorable tax treatment; *see* ¶5.2.

Capital losses for 1996 are deductible from capital gains and up to $3,000 of ordinary income, with a carryover for the excess over $3,000; *see* ¶5.3.

A sample filled-in Schedule D illustrating sales of capital assets is at ¶5.6. Sales of business assets are reported on Form 4797. As discussed in ¶44.8, most assets used in a business are considered Section 1231 assets, and capital gain or loss treatment may apply depending upon the result of a netting computation made on Form 4797 for all such assets sold during the year.

Figuring Capital Gains and Losses

¶5.1 Reporting Sales and Exchanges of Property

The tax treatment of gains and losses is not the same for all types of property sales. Tax reporting generally depends on your purpose in holding the property, as shown in the table below. Exchanges of like-kind business or investment property are subject to special rules that allow gain to be deferred, generally until you sell the property received in the exchange; *see* ¶6.1.

Gains and Losses From Sales and Exchanges of Property

Type of Property—	*Your gain is—*	*Your loss is—*	*Reported on—*
Stocks, bonds, and land held for investment; *see** for exchanges and ** for property excluded from the category of capital assets.	*Capital gain.* Net capital gains are subject to ordinary income tax rates. However, the tax rate applied to net long-term capital gains may not top 28%; *see* ¶5.2.	*Capital loss.* Capital losses are deductible from capital gains with only $3,000 of any excess deductible from ordinary income; *see* ¶5.3.	Schedule D
Business inventory, merchandise, and stock in trade; also *see*** below for other ordinary income items.	*Ordinary income.* Such property is excluded by law from the definition of capital assets.	*Ordinary loss.* Ordinary loss is not subject to the $3,000 deduction limit imposed on capital losses. However, passive loss restrictions of Chapter 10 may defer the time when certain ordinary losses are deductible.	Schedule C if self-employed; Schedule F if a farmer; Form 1065 for a business operated as a partnership; Form 1120 or 1120S for an incorporated business.
Depreciable buildings, trucks, autos, computers, machinery, fixtures, or equipment used in your business.	*Capital gain or ordinary income.* Section 1231 as explained in ¶44.8 determines whether gain is taxable as ordinary income or capital gain.	*Capital or ordinary* as determined by Section 1231; *see* ¶44.8. However, if you are considered to be an investor in a passive activity, *see* ¶10.12 and ¶10.13.	Form 4797
Home, car, jewelry, furniture, art objects, and other property held for personal use; *see*** for items that are not capital assets.	*Capital gain.* Where an asset is held both for personal and business use, such as an auto, the asset is treated as two separate assets for purposes of figuring gain or loss; *see* ¶44.12. Tax on all or part of a profit from a sale of a principal residence may be deferred; *see* Chapter 29.	*Not deductible.* Losses on assets held for personal use are not deductible although profits are taxable. However, a sale of personal assets by an executor of an estate is assumed to be profit-seeking. The estate may claim a loss on the sale of a personal asset.	If you sell your principal residence, the sale is reported on Form 2119 whether you have a gain or loss. Taxable gain, if any, is figured on Form 2119 and is also entered on Schedule D.

* **Exchanges**. An exchange of investment real estate may be made without current tax consequences; *see* ¶6.1. Unrealized gain is taxed when you sell the property taken in exchange. When property received in a tax-free exchange is held until death, the unrecognized gain escapes tax forever because the basis of property in the hands of an heir is generally the fair market value of the property at the date of death; *see* ¶5.21. A loss on a like-kind exchange is not deductible.

** **Property not treated as capital assets.** By law, the following are not treated as capital assets: (1) property held for sale to business customers; (2) depreciable property used in business; but *see* ¶44.8 for possible capital asset treatment under Section 1231 rules; (3) accounts or notes receivable which were acquired in the ordinary course of business or from the sale of inventory, or from the sale of property held for sale to customers, or acquired for services as an employee; (4) copyrights, literary, musical or artistic compositions, letters, memoranda, or similar property held by you if you personally *created* such property, or by other persons who obtained the property from the creator of the property in a tax-free exchange or as a gift; (5) letters, memoranda, or similar property that were prepared for you; and (6) U.S. government publications that you obtained free or for less than the normal sales price.

¶5.2 Net Long-Term Capital Gain

If your regular 1996 tax bracket for all income, including capital gains, does not exceed 28%, net long-term capital gains are fully taxable at your regular rate, the same as your short-term gains. However, if your regular tax bracket exceeds 28% you should compute the tax on net capital gains using the 28% maximum rate. The 28% rate applies to *net capital gains*, which are net long term capital gains minus net short-term capital losses. Gain or loss is long term if you held the asset more than one year.

Who benefits from the 28% ceiling on net capital gains? You will save taxes by applying the 28% ceiling if your 1996 taxable income, including net capital gains (excess of long-term capital gains over short-term capital losses), *exceeds:*

- $96,900 using joint return rates (including qualifying widow or widower).
- $83,050 using head of household rates.
- $58,150 using single return rates.
- $48,450 using married filing separately rates.

These amounts are the levels at which the 28% tax bracket ends and the 31% bracket begins. If your taxable income including net capital gains *does not exceed* the above amount for your filing status, you need not concern yourself with computing the 28% ceiling because your capital gains would not be subject to rates over 28% even without the ceiling.

If your 1996 taxable income including net capital gains *does exceed* the above amount, use the following worksheet or the similar IRS worksheet in the Form 1040 instructions to figure your tax liability under the special method that limits the tax rate on net capital gains to 28%.

Computing Tax Liability Using Special 28% Net Capital Gains Rate

1. Enter your taxable income.	$________
2. Enter your net capital gain from Schedule D (net long-term capital gain *minus* net short-term capital loss).	________
3. If you are claiming an itemized deduction for investment interest (¶15.10) and on Form 4952 you elected to treat some or all of your net capital gains as investment income, enter that elected amount here.*	________
4. Subtract Line 3 from Line 2.	________
5. Subtract Line 4 from Line 1. This is taxable income without net capital gain, other than net capital gains treated as investment income on Line 3.	________
6. Enter $24,000 if you are single;** $40,100 if you use joint return rates;** $32,150 if you use head of household rates;** $20,050 if you are married filing separately.**	________
7. Enter the greater of Line 5 and Line 6.	________
8. Subtract Line 7 from Line 1. This is the amount of capital gain that benefits from the 28% rate.	________
9. Figure the tax on Line 7 using the tax rate schedule if Line 7 is $100,000 or more; use the tax tables if it is less than $100,000; *see* ¶23.1.	________
10. Multiply Line 8 by 28% and enter the result.	________
11. Add Lines 9 and 10.	________
12. Figure the tax on Line 1 using the tax rate schedule if Line 1 is $100,000 or more; use the tax tables if it is less than $100,000; *see* ¶23.1.	________
13. Enter the *smaller* of Line 11 and Line 12. This is your total tax liability which you enter on Form 1040.	$________

* Net capital gains included on Form 4952 do not qualify for the special 28% rate; thus, they are subtracted on Lines 3 and 4 of the worksheet. Generally, making the election on Form 4952 to include net capital gain as investment income is advisable if your other investment income is less than your investment interest expense. *See* ¶15.10 for further details.

** These amounts are the taxable income levels above which the 28% rate starts in the 1996 tax rate schedules.

EXAMPLE

You and your spouse file a 1996 joint return showing a taxable income of $125,000, which includes a net capital gain of $15,000. You do not elect to treat any net capital gain as investment income on Form 4952. The alternative tax computation using the 28% maximum capital gain rate reduces your 1996 taxes by $450. The line numbers correspond to the lines of the worksheet on the previous page.

1. Taxable income	$125,000
2. Net capital gain	15,000
3. Net capital gain included as investment income on Form 4952	0
4. Line 2 *minus* Line 3	15,000
5. Line 1 *minus* Line 4	110,000
6. Starting point for 28% tax rate on joint return 40,100	
7. Greater of Lines 5 and 6	110,000
8. Line 1 *minus* Line 7. This is net capital gain subject to ceiling	15,000
9. Tax on Line 7	25,980
10. 28% of $15,000 on Line 8	4,200
11. Add Lines 9 and 10.	$30,180
12. Tax on Line 1	30,630
13. Smaller of Lines 11 and 12. This is the alternative tax including the 28% ceiling for net capital gain	30,180

The alternative tax of $30,180 provides a tax savings of $450, compared to the $30,630 tax that would apply without it. The savings is on the $15,000 of net capital gain that would otherwise be taxed at 31%. The amount of the savings is the 3% difference between the 28% ceiling and the 31% regular rate, or $450 (3% of $15,000).

If an election had been made on Form 4952 to treat some of the $15,000 net capital gain as investment income eligible for the investment interest deduction (¶15.10), the amount of the election would reduce the $15,000 eligible here for the 28% special rate.

Ceiling for High Earners May Top 28%

The actual rate on long-term capital gains will be higher than 28% for taxpayers subject to the 3% reduction to itemized deductions (¶13.8) and the phaseout of personal exemptions (¶22.15). Chapter 28 explains how these restrictions increase the capital gains rate.

¶5.3 Capital Losses and Carryovers

Capital losses are fully deductible against capital gains, and if losses exceed gains, you may deduct the excess from up to $3,000 of other income on Form 1040. Net losses over $3,000 are carried over to future years. The $3,000 limit is reduced to $1,500 for married persons filing separately.

If you have a net short-term loss and net long-term gain, or net long-term loss and net short-term gain, you offset the loss against the gain on Line 18 of Schedule D. Losses exceeding gains, up to the $3,000 limit ($1,500 if married filing separately), are entered on Line 19 and then deducted from income on Line 13 of Form 1040. In preparing your 1996 Schedule D, remember to include any capital loss carryovers from your 1995 return.

Carryover for nondeductible losses. The carryover for both long- and short-term losses, which keep their character over the carryover period, is computed on the worksheet at the end of this section. If the original loss is short term, the carryover is short term; if it is long term, the carryover is long term.

If you have both a net short-term capital loss and a net long-term capital loss that together exceed $3,000, the short-term loss is used up first against the $3,000 limit in figuring the amount to be carried over. Unused carryovers of a deceased person may not be used by his or her estate.

A special computation may increase your carryover deduction where you have "negative" taxable income; *see* below.

Carryover if you have "negative" taxable income. Generally, a net capital loss of up to $3,000 ($1,500 if married filing separately) is claimed on Form 1040 as a deduction from gross income and there is no carryover. However, if without considering personal exemptions, you have a "negative taxable income," the loss may not provide a tax benefit because other deductions have reduced taxable income to zero. In this case, you may be allowed a capital loss carryover for all or part of your net capital loss.

To determine the amount of the carryover, follow the steps of the worksheet. You first will figure how much of your net loss is treated as "used up" in the current year. The balance of the loss, if any, is carried over to the next year.

CAPITAL LOSS CARRYOVER WORKSHEET

1. Enter amount from Line 35 of Form 1040 (adjusted gross income minus itemized deductions or standard deduction). $________
2. Net capital loss for year (after combining all short-term and long-term gains and losses). Enter loss as a positive number. ________
3. Add Lines 1 and 2. If zero or less, enter zero. ________
4. Enter the smaller of Lines 2 and 3.
   If you had a net short-term loss, go to Line 5. Otherwise, go to Line 10. ________
5. Enter your net short-term loss, if any (short-term losses over short-term gains), as a positive number.
   If you did not have a net short-term loss, skip Lines 6 through 9 and go to Line 10. ________
6. Enter your net long-term gain, if any (long-term gains over long-term losses). ________
7. Enter amount from Line 4. ________
8. Add Lines 6 and 7. ________
9. Subtract Line 8 from Line 5. If zero or less, enter zero. *This is your short-term capital loss carryover to the next year.*
   If you had a net long-term loss (long-term losses over long-term gains) go on to Line 10. ________
10. Enter your net long-term loss, if any (long-term losses over long-term gains), as a positive number. ________
11. Enter your net short-term gain, if any (short-term gains over short-term losses). ________
12. Subtract Line 5 from Line 4. If zero or less, enter zero. ________
13. Add Lines 11 and 12. ________
14. Subtract Line 13 from Line 10. If zero or less, enter zero. *This is your long-term capital loss carryover to the next year.* ________

¶5.4 Capital Losses of Married Couples

On a joint return, the capital asset transactions of both spouses are combined and reported on one Schedule D. A carryover loss of one spouse may be applied to capital gains of the other spouse. Where you and your spouse separately incur net capital losses, $3,000 is the maximum capital loss deduction that may be claimed for the combined losses on your joint return. This rule may not be avoided by filing separate returns. If you file separately, the deduction limit for each return is $1,500.

EXAMPLE

In 1996, you and your spouse individually incurred net long-term capital losses of $5,000 and $4,000. If you file separate returns, the maximum amount deductible from ordinary income on each return is $1,500. The balance must be carried forward to 1997.

Death of a spouse. The IRS holds that if a capital loss is incurred by a spouse on his or her own property and that spouse dies, the surviving spouse may not claim any unused loss carryover on a separate return.

EXAMPLE

In 1993, Alex Smith realized a substantial net long-term capital loss on separately owned property, which was reported on a 1993 joint return filed with his wife, Anne. Part of the excess loss was carried over to the couple's 1994 joint return, and in 1995, before the carryover loss was used up, Alex died. Anne could claim the unused carryover, up to the $3,000 limit, on a joint return filed for 1995, the year of Alex's death. However, any remaining loss carryover to 1996 or later years is lost. Although the loss was originally reported on a joint return, Anne may claim only her allocable share of the loss on her individual returns for years after 1995. However, since the loss property was owned solely by Alex, no part of the loss is allocable to Anne.

¶5.5 Defer Gain on Rollover to SSBIC

You may be able to defer taxable gain on the sale of publicly traded securities provided the sale proceeds are rolled over within 60 days into common stock or a partnership interest in a "specialized small business investment company," or SSBIC. The entire gain is deferrable if the cost of your SSBIC stock or partnership interest is at least equal to the sale proceeds. If the SSBIC investment is less than the sale proceeds, your gain is taxed to the extent of the difference.

To elect deferral, you must report the sale on Schedule D, and attach an explanation of your SSBIC investment; follow the Schedule D instructions. The deferred gain reduces the basis of your SSBIC stock or partnership interest. The deferral rule applies to sales of publicly traded securities after August 9, 1993.

An SSBIC is a small business (partnership or corporation) licensed by the Small Business Administration to invest in small businesses which are owned by socially or economically disadvantaged individuals.

Limit on deferrable amount. The amount of gain you may annually elect to roll over is limited to $50,000, or $25,000 if you are married filing separately. There is a lifetime limit of $500,000, or $250,000 if married filing separately.

¶5.6 Sample Schedule D

You report many different types of transactions on Schedule D: sales of securities; mutual fund shares; worthless personal loans; sales of stock rights and warrants; sales of land held for investment; and in some cases sales of personal residences. You enter short-term transactions in Part I of Schedule D and long-term transactions in Part II. If you need more space, use Part IV as a continuation of Part I for reporting short-term transactions, and Part V as a continuation of Part II for reporting long-term transactions.

Different types of Schedule D entries are illustrated in the sample worksheet on the next page. The entries correspond to the following transactions. For each transaction, assume that broker's commissions and state and local transfer taxes, if any, are added to the cost of the stock.

1. ***Sale of stock (short-term gain)***—You bought 200 shares of Buma Rubber stock on July 22, 1996, for $400. On October 11, 1996, you sell the 200 shares for $600.
2. ***Sale of stock received as a gift (short-term loss)***—Your father gave you a gift of 100 shares of Ajax Auto stock on March 16, 1996, which he had bought on February 15, 1961, for $4,000. The value of the stock at the time of the gift was $3,000. You sell the stock on March 29, 1996, for $2,500. Since the value of the stock at the time of the gift was less than your father's basis, your basis for loss purposes is the date-of-gift value (¶5.21) and the holding period begins on the day after the date of the gift (¶5.16).
3. ***Worthless personal loan***—You loaned $500 to your friend, Dan Debtor, on May 1, 1990. He was adjudged bankrupt on March 15, 1996; *see* ¶5.9. The IRS requires that you explain the deduction in a statement attached to your return. The statement should show: (1) the nature of the debt; (2) the name of the debtor and his or her relationship, if any, to you; (3) when the debt was due; (4) how you tried to collect it; and (5) how you determined it was worthless.
4. ***Short sale***—You sold "short" 100 shares of Fast Co. on September 9, 1996, for $9,000. You closed this sale on October 21, 1996, by buying 100 shares for $8,500 and delivering them to your broker; *see* ¶30.6.
5. ***Call***—On June 3, 1996, you bought a 60-day call on 100 shares of Sand Corp. for $500. You did not exercise it; *see* ¶30.10.
6. ***Sale of stock (long-term gain)***—You bought 100 shares of Acme Steel stock on October 1, 1991, for $5,000. On December 12, 1996, you sell the 100 shares for $6,000.
7. **Sale of stock received as a gift (long-term gain)**—Your father gave you a gift of 100 shares of Crown Auto stock on March 16, 1996, which he had bought on May 18, 1960, for $4,000. The fair market value of the stock at the time of the gift was $5,900. On March 22, 1996, you sell the stock for $8,000. Your father paid no gift tax under the annual $10,000 exclusion (¶33.1). Since the date-of-gift value exceeded your father's basis, your basis is your father's basis of $4,000 (¶5.21) and your holding period includes your father's holding period (¶5.16).
8. ***Sale of stock received as inheritance (long-term gain)***—You inherited 300 shares of Davis Textile preferred stock from your father, who died on January 14, 1994. He had bought them in 1941 for $1,500. When he died, they were selling on the exchange for $15,000, at which value they were reported for estate tax purposes. You received the stock on February 23, 1996, when they were selling at $18,000. You sold the stock for $20,000 on June 7, 1996. Your basis for the property is the date-of-death value (¶5.21) of $15,000. You treat the sale as a long-term transaction (¶5.16) even though you held the stock for less than one year.
9. ***Sale of stock including stock dividends***—You bought 100 shares of Box Co. stock for $1,000 on June 20, 1984. In 1993, you received a stock dividend of 10 shares and, in 1994, a stock dividend of 40 shares. On March 4, 1996, you sell the 150 shares for $3,000; *see* ¶30.4.
10. ***Sale of stock dividend***—You bought 100 shares of Bale Co. stock for $1,200 on January 5, 1990. You received a tax-free dividend for 20 shares on April 19, 1995. You sell the 20 dividend shares on June 18, 1996, for $300; *see* ¶30.4.
11. ***Sale of stock rights***—You bought 100 shares of Tel. Co. stock for $5,000 on January 3, 1962. On January 5, 1996, you receive stock rights to subscribe to 10 shares at $53 a share. The stock is worth $55 a share (ex-rights). You sell the rights for $20 on February 5, 1996; *see* ¶30.5.
12. ***Worthless bonds***—On August 10, 1971, you bought two $1,000 bonds of Rail Co. at par. These bonds became completely worthless during 1996; *see* ¶5.7.
13. ***Sale of lot***—On June 14, 1961, you bought a parcel as an investment for $600. On March 25, 1996, you sell it for $2,000.
14. ***Sale of stock bought at various times***—You bought 100 shares of Computer Company on March 13, 1991, for $4,000. On May 20, 1992, you bought another 100 shares for $4,500 and on September 19, 1995, another 100 shares for $5,000. On December 18, 1996, you sell all 300 shares for $12,600.

Summary of gains and losses. Combining the $700 of short-term gains and $1,500 of short-term losses on Line A of the worksheet gives you a net short-term loss of $800. Combining the $13,520 of long-term gains and the $2,900 of long-term losses on Line B of the worksheet gives you a net long-term gain of $10,620.

For the year, you have a net capital gain of $9,820, the excess of net long-term gain ($10,620) over net short-term loss ($800). *See* ¶5.2 to determine whether you can benefit from the maximum 28% rate on net capital gain.

IRS review. The IRS compares the proceeds that are reported on Schedule D with the selling prices reported on Form 1099-B and Form 1099-S. If you receive an incorrect Form 1099-B or 1099-S, report the proper amount and attach a statement explaining the difference between the amount you entered on Schedule D and the amount shown on the Form 1099.

Schedule D — Worksheet

Short-Term Capital Gains and Losses—Assets Held One Year or Less

	(a) Description of property (Example, 100 shares of XYZ Co.)	(b) Date acquired (Mo., day, yr.)	(c) Date sold (Mo., day, yr.)	(d) Sales price	(e) Cost or other basis	(f) LOSS If (e) is more than (d), subtract (d) from (e)	(g) GAIN If (d) is more than (e), subtract (e) from (d)
(1)	200 Sh-Buna Rubber	7-22-96	10-11-96	600	400		200
(2)	100 Sh- Ajax Auto	3-16-96	3-27-96	2,500	3,000	500	
(3)	Dan Debtor	Worthless Loan —			Statement attached	500	
(4)	100 Sh- Fast Co.	10-21-96	9-9-96	9,000	8,500		500
(5)	Call - Sand Corp.	6-3-96	Expired		500	500	
(A)	Short-term totals.			12,100		1,500	700

Long-Term Capital Gains and Losses—Assets Held More Than One Year

	(a)	(b)	(c)	(d)	(e)	(f)	(g)
(6)	100 Sh-Acme Steel	10-1-91	12-12-96	6,000	5,000		1,000
(7)	100 Sh-Crown Auto	5-18-60	3-22-96	8,000	4,000		4,000
(8)	300 Sh-Davis Textile	"Inherited"	6-7-96	20,000	15,000		5,000
(9)	150 Sh - Box Co.	6-20-84	3-4-96	3,000	1,000		2,000
(10)	20 Sh- Gale Co.	1-5-90	6-18-96	300	200		100
(11)	Stock Rights—Tel. Co.	1-3-62	2-5-96	20			20
(12)	Two Worthless Bonds - Rail Co.	8-10-71	Worthless		2,000	2,000	
(13)	Lot— 100 Allen Rd. City, State	6-14-61	3-25-96	2,000	600		1,400
(14)	300 Sh- Computer Co.	"Various"	12-19-96	12,600	13,500	900	
(B)	Long-term totals.			51,920		2,900	13,520

Worthless Securities and Bad Debt Deductions

¶5.7 Worthless Securities

You may deduct as a capital loss on Schedule D the cost basis of securities that have become worthless in 1996. Capital loss treatment applies unless ordinary loss treatment is available under ¶5.8.

A loss of worthless securities is deductible only in the year the securities become *completely worthless*. The loss may not be deducted in any other year. Because it is sometimes difficult to determine the year in which a security becomes *completely* worthless, the law allows you to file a refund claim within *seven years* from the due date of the return for the proper year (the year the security actually became completely worthless).

You may not claim a loss for *partially worthless* stock. However, if there is a market for it, sell the stock and deduct the loss.

To support a deduction for 1996 you must show:

1. The stock had some value in 1995. That is, you must be ready to show that the stock did not become worthless in a year prior to 1996. If you learn that the stock did become worthless in a prior year, file an amended return for that year; *see* Filing Pointer on refunds in the next column.
2. The stock became totally worthless in 1996. You must be able to present facts fixing the time of loss during this year. For example, the company went bankrupt, stopped doing business, and is insolvent. Despite evidence of worthlessness, such as insolvency, the stock may be considered to have some value if the company continues to do business, or there are plans to reorganize the company. No deduction may be claimed for a partially worthless corporate bond.

If you are making payments on a negotiable note you used to buy the stock that became worthless and you are on the cash-basis method, your payments are deductible losses in the years the payments are made, rather than in the year the stock became worthless.

If the security is a bond, note, certificate, or other evidence of a debt incurred by a corporation, the loss is deducted as a capital loss, provided the obligation is in registered form or has attached interest coupons. A loss on a worthless corporate obligation is always deemed to have been sustained on the last day of the year, regardless of when the company failed during the year.

If the obligation is not issued with interest coupons or in registered form, or if it is issued by an individual, the loss is treated as a bad debt. If you received the obligation in a business transaction, the loss is fully deductible. You may also make a claim for a partially worthless business bad debt. If it is a nonbusiness debt, the loss is a capital loss and no claim may be made for partial worthlessness; *see* ¶5.9.

Refund Deadline for Worthless Stock

You have seven years from the due date of your return to claim a refund based on a deduction of a bad debt or worthless security.

For example, if you have held securities that you learn became worthless in 1989, you still have until April 15, 1997, to file for a refund of 1989 taxes by claiming a deduction for the worthless securities on an amended return (Form 1040X) for 1989.

When To Deduct Worthless Stock

If at the end of 1996 a company is in financial trouble but you are not sure whether its condition is hopeless, it is advisable to claim the deduction for 1996 to protect your claim. This advice was given by a court: "The taxpayer is at times in a very difficult position in determining in what year to claim a loss. The only safe practice, we think, is to claim a loss for the earliest year when it may possibly be allowed and to renew the claim in subsequent years if there is a reasonable chance of its being applicable for those years."

If you claim the deduction for 1996 and it turns out that complete worthlessness did not occur until a later year, claim the deduction for the proper year and then file an amended return for 1996 to eliminate the deduction.

Sometimes you can avoid the problem of proving worthlessness. If there is still a market for the security, you can sell. For example, the company is on the verge of bankruptcy, but in 1996 there is some doubt about the complete worthlessness of its securities. You might sell the securities for whatever you can get for them and claim the loss on the sale. However, if the security became worthless in a prior year, say in 1995, a sale in 1996 will not give you a deduction in 1996.

Long-term or short-term loss. A sale is presumed to have occurred at the end of the year, regardless of when worthlessness actually occurred during the year.

EXAMPLE

You bought 100 shares of Z Co. stock on July 1, 1980. On March 15, 1996, the stock is considered wholly worthless. The loss is deemed to have been incurred on December 31, 1996. The loss is deducted as a long-term capital loss; the holding period is from July 1, 1980, to December 31, 1996.

Ordinary loss on Small Business Investment Company (SBIC) stock. On Form 4797, investors may take ordinary loss deductions for losses on the worthlessness or sale of SBIC stock. The loss may also be treated as a business loss for net operating loss purposes. However, a loss realized on a short sale of SBIC stock is deductible as a capital loss. A Small Business Investment Company is a company authorized to provide small businesses with equity capital. Do not confuse investments in these companies with investments in small business stock (Section 1244 stock) discussed at ¶5.8.

S corporation stock. If an S corporation's stock becomes worthless during the taxable year, the basis in the stock is adjusted for the stockholder's share of corporate items of income, loss, and deductions before a deduction for worthlessness is claimed.

Bank deposit loss. If you lose funds in a bank that becomes insolvent, you may claim the loss as a nonbusiness bad debt (¶5.9), a casualty loss (¶18.4), or in some cases, an investment expense (¶19.24).

¶5.8 Ordinary Loss for Small Business Stock (Section 1244)

Shareholders of qualifying "small" corporations may claim within limits an ordinary loss, rather than a capital loss, on the sale or worthlessness of Section 1244 stock. An ordinary loss up to $50,000, or $100,000 on a joint return, may be claimed in Part II of Form 4797. On a joint return, the $100,000 limit applies even if only one spouse has a Section 1244 loss. Losses in excess of these limits are deductible as capital losses. Gains on Section 1244 stock are reported as capital gain on Schedule D.

An ordinary loss may be claimed only by the original owner of the stock. If a partnership sells Section 1244 stock at a loss, an ordinary loss deduction may be claimed by individuals who were partners when the stock was issued. If a partnership distributes the Section 1244 stock to the partners, the partners may not claim an ordinary loss on their disposition of the stock.

If an S corporation sells Section 1244 stock at a loss, S corporation shareholders may not claim an *ordinary* loss deduction. The IRS with Tax Court approval limits shareholders' deductions to capital losses (which are deductible only against capital gains plus $3,000; *see* ¶5.3).

To qualify as Section 1244 stock:

1. The corporation's equity may not exceed $1,000,000 at the time the stock is issued, including amounts received for the stock to be issued. Thus, if the corporation already has $600,000 equity from stock previously issued, it may not issue more than $400,000 worth of additional stock.

   If the $1,000,000 equity limit is exceeded, the corporation follows an IRS procedure for designating which shares qualify as Section 1244 stock.

   Preferred stock issued after July 18, 1984, may qualify for Section 1244 loss treatment, as well as common stock.
2. The stock must be issued for money or property (other than stock and securities).
3. The corporation for the five years preceding your loss must generally have derived more than half of its gross receipts from business operations and not from passive income such as rents, royalties, dividends, interest, annuities, or gains from the sales or exchanges of stock or securities. The five-year requirement is waived if the corporation's deductions (other than for dividends received or net operating losses) exceed gross income. If the corporation has not been in existence for the five years before your loss, then generally the period for which the corporation has been in existence is examined for the gross receipts test.

Recordkeeping requirements. You must keep records that distinguish between Section 1244 stock and other stock interests. Your records must show that the corporation qualified as a small business corporation when the stock was issued, you are the original holder of the Section 1244 stock, and it was issued for money or property. Stock issued for services does not qualify. In addition, the records should also show the amount paid for the stock, information relating to any property transferred for the stock, any tax-free stock dividends issued on the stock, and the corporation's gross receipts data for the most recent five-year period.

Failure to keep these records will be grounds for disallowing a loss claimed on Section 1244 stock.

¶5.9 Tax Consequences of Bad Debts

When you lend money or sell on credit and your debtor does not repay, you may deduct your loss. The type of deduction depends on whether the debt was incurred in a business or personal transaction. This distinction is important because business bad debts receive favored tax treatment.

Business bad debt. A business bad debt is fully deductible from gross income on Schedule C if you are self-employed, or on Schedule F if your business is farming. In addition, you may deduct partially worthless business debts. You must use the specific charge-off method for deducting business bad debts. If you use the accrual method for reporting income for services, you may be able to account for bad debts by not having to accrue income that you do not expect to collect; *see* IRS Publication 334 or 535 for details.

Examples of business debt transactions:

- You sell merchandise on credit and later the buyer becomes insolvent and does not pay.
- You are in the business of making loans and a loan goes bad.
- You sell your business, but retain some accounts receivable. Later, some of these become worthless.
- You liquidate your business and are unable to collect its outstanding accounts.
- You operate as a promoter of corporations.
- You finance your lessees, customers, or suppliers to help your business.
- You lend money to protect your professional and business reputation.

- You lend money to insure delivery of merchandise from a supplier.
- You make a loan to your employer to keep your job.

CAUTION

Accounts and Notes Receivable

You may claim a bad debt deduction for accounts and notes receivable on unpaid goods or services only if you have included the amount due as gross income. Thus, if a client or customer fails to pay a bill for services rendered, you do not have a deductible bad debt where you have not reported the amount as income.

Nonbusiness bad debt. A nonbusiness bad debt is deducted as a short-term capital loss on Schedule D. This is a limited deduction. In 1996, you deduct it from capital gains, if any, and $3,000 of other income. Any excess is deductible as a capital loss carryover in 1997 and later years; *see* ¶5.3. You may not deduct partially worthless nonbusiness bad debts. The debt must be totally worthless.

Examples of nonbusiness bad debts:

- You enter into a deal for profit which is not connected with your business; for example, debts arising from investments are nonbusiness bad debts.
- You make a personal loan to a family member or friend with a reasonable hope of recovery and are not in the business of making loans.
- You are assigned a debt that arose in the assignor's business. The fact that he or she could have deducted it as a business bad debt does not make it your business debt. A business debt must arise in your business.
- You pay liens filed against your property by mechanics or suppliers who have not been paid by your builder or contractor. Your payment is considered a deductible bad debt when there is no possibility of recovering reimbursement from the contractor and a judgment obtained against him or her is uncollectible.
- You lose a deposit on a house when the contractor becomes insolvent.
- You loan money to a corporation in which you are a shareholder, and your primary motivation is to protect your investment rather than your job; *see* ¶5.11.
- You had an uninsured savings account in a savings association which went into default; *see* ¶18.4.
- You are held secondarily liable on a mortgage debt assumed but not paid by a buyer of your home. Your payment to the bank or other holder of the mortgage is deductible as a bad debt if you cannot collect it from the buyer of the home.

¶5.10 Four Rules To Prove a Bad Debt Deduction

To determine whether you have a bad debt deduction in 1996, read the four rules explained below. Pay close attention to the fourth rule, which requires proof that the debt became worthless in the year the deduction is claimed. Your belief that your debt is bad, or the mere refusal of the debtor to pay, is not sufficient evidence. There must be an event, such as the debtor's bankruptcy, to fix the debt as worthless.

Rule 1. You must have a valid debt. You have no loss if your right to repayment is not fixed or depends upon some event which may not happen. Thus, advances to a corporation already insolvent are not valid debts. Nor are advances that are to be repaid only if the corporation has a profit. Voluntary payment of another's debt is also nondeductible. If usurious interest was charged on a worthless debt, and under state law the debt was void or voidable, the debt is not deductible as a bad debt. However, where the lender was in the business of lending money, a court allowed him to deduct the unpaid amounts as business losses.

If advances are made to a company that has lost outside borrowing sources and is thinly capitalized, with heavy debt-to-equity ratio, this indicates that the advances are actually capital contributions and not loans.

Rule 2. A debtor-creditor relationship must exist at the time the debt arose. You have a loss if there was a promise to repay at the time the debt was created and you had the right to enforce it. If the advance was a gift and you did not expect to be repaid, you may not take a deduction. Loans to members of your family, to a controlled corporation, or to a trust may be treated as gifts or contributions to capital.

Rule 3. The funds providing the loan or credit were previously reported as income or part of your capital. If you are on the cash basis, you may not deduct unpaid salary, rent, or fees. On the cash basis, you do not include these items in income until you are paid.

Rule 4. You must show that the debt became worthless during 1996. To prove the debt became worthless in 1996, you must show:

First, that the debt had some value at the end of the previous year (1995), and that there was a reasonable hope and expectation of recovering something on the debt. Your personal belief unsupported by other facts is not enough.

Second, that an identifiable event occurred in 1996—such as a bankruptcy proceeding—that caused you to conclude the debt was worthless. In the case of a business debt which has become partially worthless, you need evidence that the debt has declined in value. Additionally, reasonable collection steps must have been undertaken. That you cancel a debt does not make it worthless. You must still show that the debt was worthless when you cancelled it. You do not have to go to court to try to collect the debt if you can show that a court judgment would be uncollectible.

Third, that there is no reasonable hope the debt may have some value in a later year. You are not required to prove that there is no possibility of ever receiving some payment on your debt. You are not expected to be an extreme optimist.

Debt Worthless Before Due

You do not have to wait until the debt is due in order to deduct a bad debt. Claim the deduction for the year that you can prove worthlessness occurred.

Effect of statute of limitations. A debt is not deductible merely because a statute of limitations has run against the debt. Although the debtor has a legal defense against your demand for payment, he or she may still recognize the obligation to pay. A debt is deductible only in the year it becomes worthless. This event—for example, the debtor's insolvency—may have occurred even before the statute became effective.

What if your debtor recognized his or her moral obligation to pay in spite of the expiration of the statute of limitations, but dies before paying? Your claim would be defeated if the executor raises the statute of limitations. You then have a bad debt deduction in the year you made the claim against the estate.

Guarantor or endorsement losses as bad debts. If you guarantee a loan and must pay it off after the principal debtor defaults, your payment is deductible as a business bad debt if you had a business reason for the guarantee. For example, to protect a business relationship with a major client, you guarantee the client's loan. Your payment on the guarantee qualifies as a business bad debt. If as a result of your payment, you have a legal right to recover the amount from the client (right of subrogation or similar right), you may not claim a bad debt deduction unless that right is partially or totally worthless.

A loss on a guarantee may be a nonbusiness bad debt if you made the guarantee to protect an investment, such as where you are a main shareholder of a corporation and guarantee a bank loan to the company. No deduction is allowed if you guaranteed the loan as a favor to a relative or friend.

Bank deposit losses are discussed at ¶18.4.

¶5.11 Loans by Stockholders

It is a common practice for stockholders to make loans to their corporations or to guarantee loans made by banks or other lenders. If the corporation fails and the stockholder is not repaid or has to make good on the guarantee, he or she is generally left with a nonbusiness bad debt (nonbusiness bad debts are deductible only as a short-term capital loss on Schedule D; *see* ¶5.9) unless he or she can prove that a business loan was made (business bad debts are fully deductible on Schedule C). To prove a business loan, the stockholder usually has to show *one* of these facts:

1. He or she is in the business of making loans and the loan was made in that capacity; or he or she is in the business of promoting corporations for a fee or for profits on their sale.
2. He or she made the loan to safeguard the business.
3. He or she wanted to protect his or her job with the company.

Loan to Protect Job

A Supreme Court test requires a shareholder-employee claiming a business bad debt deduction to show that the primary and dominant motive of the loan was to protect his or her job, rather than investment in the company; *see* the following Examples.

EXAMPLES

1. To determine an executive's motive for making a loan, the Supreme Court reviewed his salary, outside income, investment in the company, and the size of his loan. His pay was $12,000 ($7,000 after tax); his outside income was $30,000. He had a $38,900 investment in the company and loaned it $165,000. On the basis of these figures, the Court concluded he could not have advanced $165,000 to protect an after-tax salary of $7,000. He was protecting his investment, not his job, and only a nonbusiness bad debt could be claimed.

2. Litwin founded several energy start-up companies after he retired in 1974 from the Litwin Corporation. In 1980, he founded AFS, to which he made loans of $150,000 and guaranteed another $350,000 of loans. AFS went bankrupt in 1984.

   A federal appeals court followed the Supreme Court's approach (Example 1) to determine that Litwin had an employment-related motive for the loans. His primary reason for setting

up the company was to stay employed and remain "useful" to society. Given his background and advanced age, his best chance for ongoing employment was to start his own company. The majority of his time and energy was spent on AFS, even after he sold his controlling interest in the corporation and had only limited opportunities to capitalize on his remaining investment. True, Litwin deferred his salary for three years, but evidence showed that he intended to draw a salary in the future. Most importantly, Litwin took a sizeable risk when he personally guaranteed loans that exceeded his investment in AFS. The court noted that a taxpayer is probably not attempting to protect an investment in a company when guaranteed loans far exceed the value of the investment.

Loan to key employees. A loan by a stockholder to key employees was held to be a business bad debt in the following case.

EXAMPLE

Carter, the president and majority owner of two corporations, loaned money to two key employees to buy stock in the corporations. He wanted to guarantee the employees' future participation in the company. Both corporations went bankrupt, and the employees defaulted on the loans. Carter deducted both loans as business bad debts, contending he was protecting his job.

The IRS argued he had a nonbusiness bad debt; he was merely protecting his investment as a stockholder. The Tax Court disagreed. He made the loans to encourage the future of a business which would provide him salary income rather than dividends or appreciation on his stock.

When liquidation proceeds are insufficient to repay a stockholder for his or her loan and the stock is redeemed, the proceeds are first applied to the loan and then to the stock.

¶5.12 Family Bad Debts

The IRS views loans to relatives, especially to children and parents, as gifts, so that it is rather difficult to deduct family bad debts.

Overcoming IRS Gift Presumption

To overcome the presumption of a gift when you advance money to a relative, take the same steps you would in making a business loan. Take a note, set a definite payment date, and require interest and collateral. If the relative fails to pay, make an attempt to collect. Failure to enforce collection of a family debt is viewed by the courts as evidence of a gift, despite the taking of notes and the receipt of interest.

Husband's default on child support—a basis for wife's deductible bad debt? A wife who supports her children when her husband defaults on court-ordered support payments may consider claiming her expenses as a nonbusiness bad debt deduction, arguing that her position is similar to a guarantor who pays a creditor when the principal debtor defaults. The IRS does not agree with the grounds of such a claim and will disallow the deduction; its position is supported by the Tax Court.

However, the federal appeals court for the Ninth Circuit left open the possibility that such a claim may have merit if a wife can show: (1) what she spent on the children; and (2) that her husband's obligation to support was worthless in the year the deduction is claimed.

The Tax Court has subsequently reiterated its position that defaulted child support payments are not a basis for a bad debt deduction. Following these Tax Court decisions, the IRS also announced its continuing opposition to the Ninth Circuit's suggestion that a deduction may be possible. The IRS holds that since the support obligation of the defaulting spouse is imposed directly by the divorce court, the other parent who pays support to make up for the arrearage has no "basis" to support a bad debt deduction.

Counting the Holding Period for Capital Assets

¶5.13 Long-Term or Short-Term Holding Period

The period of time you own a capital asset before its sale or exchange determines whether gain or loss is short term or long term.

Long-Term Holding Period for 1996 Sales

Gains or losses in 1996 and in later years are long term if the property was held more than one year.

Rules for counting the holding period:

1. A holding period is figured in months and fractions of months.
2. The beginning date of a holding month is generally the day after the asset was acquired. The same numerical date of each following month starts a new holding month regardless of the number of days in the preceding month.
3. The last day of the holding period is the day on which the asset is sold.

As a rule of thumb, use the numerical date on which you acquired the asset as the numerical date ending a holding month in each following month. However, if you acquire an asset on the last day of a month, a holding month ends on the last day of a following calendar month, regardless of the number of days in each month.

EXAMPLES

1. On March 11, 1996, you buy stock. The holding months begin on March 12, April 12, May 12, June 12, and end on April 11, May 11, June 11, etc. A sale before March 12, 1997, will result in short-term gain or loss. If you sell on or after March 12, 1997, long-term treatment will apply; your holding period is more than one year.
2. You buy property on February 29, 1996. A holding month ends on March 31, April 30, etc. To realize long-term gain on the sale of this property, you must hold it at least one day longer than February 28, 1997.
3. You buy stock on November 30. A holding month ends on December 31, January 31, February 28 (or 29 in a leap year), etc.

¶5.14 Securities Transactions

Rules for counting your holding period for various securities transactions are as follows:

Stock sold on a public exchange. The holding period starts on the day after your purchase order is executed (trading date). The day your sale order is executed (trading date) is the last day of the holding period, even if delivery and payment are not made until several days after the actual sale (settlement date).

EXAMPLES

1. On June 3, you sell a stock at a profit. Your holding period ends on June 3, although proceeds are not received until June 6.
2. You sell stock at a gain on a public exchange on December 27, 1996. The gain must be reported in 1996 even though the proceeds are received in 1997. The installment sale rule does not apply; *see* ¶5.25.

Stock subscriptions. If you are bound by your subscription but the corporation is not, the holding period begins the day after the date on which the stock is issued. If both you and the company are bound, the acceptance of the subscription by the corporation is the date of acquisition, and your holding period begins the day after.

Tax-free stock rights. When you exercise rights to acquire corporate stock from the issuing corporation, your holding period for the stock begins on the day of exercise, not on the day after. You are deemed to exercise stock rights when you assent to the terms of the rights in the manner requested or authorized by the corporation. An option to acquire stock is not a stock right.

Stock sold from different lots. If you purchased shares of the same stock on different dates and cannot determine which shares you are selling, the shares purchased at the earliest time are considered the stock sold first; this is called the FIFO (first-in, first-out) method; *see* ¶30.3.

EXAMPLE

You purchased 10 shares of ABC stock on May 3, 1985, 10 shares of ABC stock on May 1, 1987, and 10 shares of ABC stock on September 2, 1988. In 1996, you sell 25 shares of ABC stock, and are unable to determine when those particular shares were bought. Using the "first-in, first-out" method, 10 shares are from May 3, 1985, 10 shares from May 1, 1987, and five shares from September 2, 1988. *See also* ¶30.3.

Commodities. If you acquired a commodity futures contract, the holding period of a commodity accepted in satisfaction of the contract includes your holding period of the contract, unless you are a dealer in commodities.

Employee stock options. When an employee exercises a stock option, the holding period of the acquired stock begins on the day after the option is exercised. If an employee option plan allows the exercise of an option by giving notes, the terms of the plan should be reviewed to determine when ownership rights to the stock are transferred. The terms may affect the start of the holding period for the stock.

Wash sales. After a wash sale, the holding period of the new stock includes the holding period of the old stock for which a loss has been disallowed; *see* ¶30.7.

Other references: Stock dividends, *see* ¶30.4; short sales, *see* ¶30.6; and convertible securities, *see* ¶30.8.

¶5.15 Real Estate Transactions

The holding period starts the day *after* the date of acquisition, which is the earlier of: (1) the date title passes to you; and (2) the date you take possession and you assume the burdens and privileges of ownership. In disputes involving the starting and closing dates of a holding period, you may refer to the state law that applies to your sale or purchase agreement. State law determines when title to property passes.

If your purchase of a new residence qualifies under the deferral rules discussed at ¶29.2, the holding period for the new home includes the holding period of the former residence. If you convert a residence to rental property and later sell the house, the holding period includes the time you held the house for personal purposes.

Year-end sale. The date of sale is the last day of your holding period even if you do not receive the sale proceeds until the following year. For example, you sell land at a gain on December 29, 1996, receiving payment in January 1997. The holding period ends on December 29, although the sale is reported in 1997 when the proceeds are received. Note that the December 29th gain transaction

can be reported in 1996 by making an election to “elect out” of installment reporting; *see* ¶5.27. A sale at a loss is reported in 1996.

Holding period of a newly constructed house. When you sell a newly constructed house after its completion, you may have long-term capital gain on the underlying land and both long-term and short-term capital gain on the house. The holding periods of the land and building are figured separately. The holding period of the land begins from the date of the purchase of the land (which you may have held long term before the sale). The holding period of the building follows this peculiar rule: You get long-term capital gain for that portion of the gain allocable to the cost of the building erected in the applicable long-term period before the sale. You realize short-term capital gain on the balance.

¶5.16 Gifts, Inheritances, and Other Property

Gift property. If, in figuring a gain or loss, your basis for the property under ¶5.21 is the same as the donor’s basis, you add the donor’s holding period to the period you held the property. If you sell the property at a loss using as your basis the fair market value at the date of the gift (¶5.21), your holding period begins on the day after the date of the gift.

Inherited property. The law gives an automatic long-term holding period for inherited property, regardless of the actual length of time you held the property. On Schedule D, you report the sale in Part II for long-term gains and losses; write “INHERITED” in the column for date acquired.

Where property is purchased by the executor or trustee and distributed to you, your holding period begins the day after the date on which the property was purchased.

Partnership property. When you receive property as a distribution in kind from your partnership, the period your partnership held the property is added to your holding period. But there is no adding on of holding periods if the partnership property distributed was inventory and was sold by you within five years of distribution.

Involuntary conversions. When you have an involuntary conversion and elect to defer tax on gain, the holding period for the qualified replacement property generally includes the period you held the converted property. A new holding period begins for new property if you do not make an election to defer tax.

Figuring Your Profit or Loss

¶5.17 Calculating Gain or Loss

In most cases, you know if you have realized an *economic* profit or loss on the sale or exchange of property. You know your cost and selling price. The difference between the two is your profit or loss. The computation of gain or loss for tax purposes is similarly figured, except that the basis adjustment rules may require you to increase or decrease your cost or selling price and the amount-realized rules may require you to increase the selling price. As a result, your gain or loss for tax purposes may differ from your initial calculation.

FIGURING GAIN OR LOSS ON SCHEDULE D

1. Amount realized or total selling price (¶5.18).		$______
2. Cost or other unadjusted basis (¶5.20).	$______	
3. *Plus:* Improvements; certain legal fees (¶5.24).	$______	
4. *Minus:* depreciation, casualty losses (¶5.24).	$______	
5. Adjusted basis: 2 *plus* 3 *minus* 4.	$______	
6. Add selling expenses to 5. This is the total cost shown on Schedule D.	$______	$______
7. Gain or loss: Subtract 6 from 1.		$______

EXAMPLE

You sell rental property to a buyer who pays you cash of $50,000 and assumes your $35,000 mortgage. You bought the property for $55,000 and made $12,000 of permanent improvements. You deducted depreciation of $7,250. Selling expenses were $2,000. Your gain on the sale is $23,250, figured as follows:

1.	Amount realized (¶5.18)		
	Cash	$50,000	
	Assumed mortgage	35,000	
			$85,000
2.	Original cost	55,000	
3.	*Plus* improvements	12,000	
		$67,000	
4.	*Minus* depreciation	7,250	
5.	Adjusted basis	59,750	
6.	*Plus* selling expenses*	2,000	
7.	Total cost: Combined result of Lines 2–6		61,750
8.	Gain: Subtract Line 7 from Line 1		$23,250

****Selling expenses on Schedule D.*** When reporting a sale on Schedule D, IRS instructions require you to include *selling expenses* (Step 6) in the column for *cost*, rather than as a reduction to the sales price. The only exception is where a broker has reported *net* sale proceeds (gross proceeds *less* selling expenses) on Form 1099-B; you would then report the net amount as the sales price. Where a broker has reported the *gross* sales price on Form 1099-B, the IRS wants you to treat sales commissions as an addition to cost (rather than a reduction to selling price) so that it can compare the gross amount shown on Form 1099-B with the sales price reported on your return.

Using the facts in the previous Example, you report the gross selling price of $85,000 in column (d) of Schedule D. In column (e), enter the adjusted basis of $59,750 *plus* the selling expenses of $2,000 for a total of $61,750. The final result, a gain of $23,250 ($85,000 – $61,750), is the same as if the selling price were reduced by the selling expenses.

¶5.18 Amount Realized Is the Total Selling Price

Amount realized is the tax term for the total selling price. It includes cash, the fair market value of additional property received, and any of your liabilities which the buyer agrees to pay. The buyer's note is included in the selling price at fair market value. This is generally the discounted amount that a bank or other party will pay for the note.

Sale of mortgaged property. The selling price includes the amount of the unpaid mortgage. This is true whether or not you are personally liable on the debt, and whether or not the buyer assumes the mortgage or merely takes the property subject to the mortgage. The full amount of the unpaid mortgage is included, even where the value of the property is less than the unpaid mortgage. *See also* ¶31.10 for computing amount realized on foreclosure sales.

If, at the time of the sale, the buyer pays off the existing mortgage or your other liabilities, you include the payment as part of the sales proceeds.

EXAMPLES

1. You sell property subject to a mortgage of $60,000. The seller pays you cash of $30,000 and takes the property subject to the mortgage. The sales price or "amount realized" is $90,000.
2. A partnership receives a nonrecourse mortgage of $1,851,500 from a bank to build an apartment project. Several years later, the partnership sells the project for the buyer's agreement to assume the unpaid mortgage. At the time, the value of the project is $1,400,000 and the partnership basis in the project is $1,455,740. The partnership figures a loss of $55,740, the difference between basis and the value of the project. The IRS figures a gain of $395,760, the difference between the unpaid mortgage and basis. The partnership claims the selling price is limited to the lower fair market value and is supported by an appeals court. The Supreme Court reverses, supporting the IRS position. That the value of property is less than the amount of the mortgage has no effect on the rule requiring the unpaid mortgage to be part of the selling price. A mortgagor realizes value to the extent that his or her obligation to repay is relieved by a third party's assumption of the mortgage debt.

Amount realized for home sale deferral purposes. In figuring whether you may defer the gain when you sell your principal residence and buy a new one, the "amount realized" on the sale is the net selling price—the selling price reduced by commissions, legal fees, transfer taxes, advertising costs, and other selling expenses; *see* ¶29.5.

¶5.19 Finding Your Cost

In figuring gain or loss, you need to know the "unadjusted basis" of the property sold. This term refers to the original cost of your property if you purchased it. The general rules for determining your unadjusted basis are in ¶5.20. Basis for property received by gift or inheritance is in ¶5.21; rules for surviving joint tenants are in ¶5.22. Keep in mind that you have to adjust this figure for improvements to the property, depreciation, or losses. You can find explanations for these adjustments at ¶5.24.

¶5.20 Unadjusted Basis of Your Property

To determine your tax cost for property, first find in the following section the unadjusted basis of the property, and then increase or decrease that basis as explained at ¶5.24.

Property you bought. Unadjusted basis is your cash cost *plus* the value of any property you gave to the seller. If you assumed a mortgage or bought property subject to a mortgage, the amount of the mortgage is part of your unadjusted basis.

Purchase expenses are included in your cost, such as commissions, title insurance, recording fees, survey costs, and transfer taxes.

When you buy real estate, you usually reimburse the seller for property taxes he or she paid that cover the period after you took title. If you bought the property before 1954, you add such payments to basis. If you bought the property after 1953, taxes paid are not added to basis because they are immediately deductible in the year paid; *see* ¶16.6. However, if at the closing you also paid property taxes attributable to the time the seller held the property, you add such taxes to basis.

EXAMPLE

You bought a building for $120,000 in cash and a purchase money mortgage of $60,000. The unadjusted basis of the building is $180,000.

Property obtained for services. If you paid for the property by providing services, the value of the property, which is taxable compensation, is also your adjusted basis.

Property received in taxable exchange. Technically, your unadjusted basis for the new property is the fair market value of the surrendered property at the time of exchange. In practice, however, the basis usually is equal to the fair market value of the property received. *See* below for "tax-free" exchanges.

EXAMPLE

You acquire real estate for $35,000. When the property has a fair market value of $40,000, you exchange it for machinery also worth $40,000. You have a gain of $5,000 and the basis of the machinery is $40,000.

Property received in a "tax-free" exchange. The computation of basis is made on Form 8824. If the exchange is completely tax free (¶6.1), your basis for the new property will be your basis for the property you gave up in the exchange, *plus* any additional cash and exchange expenses you paid.

If the exchange is partly nontaxable and partly taxable because you received "boot" (¶6.3), your basis for the new property will be your basis for the property given up in the exchange, *decreased* by any cash received and by any liabilities on the property you gave up, and *increased* by any cash and exchange expenses you paid, liabilities on the property you received, and gain taxed to you on the exchange. Gain is taxed to the extent you receive "boot," in the form of cash or a transfer of liabilities that exceeds the liabilities assumed in the exchange; *see* ¶6.3 for a discussion on taxable boot.

The Example at ¶6.3 illustrates the basis computation.

EXAMPLES

1. You exchange investment real estate, which cost you $20,000, for other investment real estate. Both properties have a fair market value of $35,000 and neither property is mortgaged. You pay no tax on the exchange. The unadjusted basis of the new property received in the exchange is $20,000.
2. Same facts as in Example 1 but you receive real estate worth $30,000 and cash of $5,000. On this transaction, you realize gain of $15,000 (amount realized of $35,000 *less* your basis of $20,000), but only $5,000 of the gain is taxable, equal to the cash "boot" received. Your basis for the new property is $20,000 figured this way:

Basis of old property	$20,000
Less: Cash received	5,000
	15,000
Plus: Gain recognized	5,000
Basis of new property	$20,000

Property received from a spouse or former spouse. As explained at ¶6.6, tax-free exchange rules apply to property transfers after July 18, 1984, to a spouse, or to a former spouse where the transfer is incident to a divorce. The spouse receiving the property takes a basis equal to that of the transferor. Certain adjustments may be required where a transfer of mortgaged property is made in trust.

If you received property before July 19, 1984, under a prenuptial agreement in exchange for your release of your dower and marital rights, your basis is the fair market value at the time you received it.

New residence purchased under tax deferral rule. If you sell your old principal residence and buy a qualifying replacement under the rules of ¶¶29.2–29.5, your basis for the new house is what you paid for it, less any gain that was not taxed on the sale of the old residence. *See also* the Example of basis computation at the end of ¶29.5.

Property received as a trust beneficiary. Generally, you take the same basis the trust had for the property. But if the distribution is made to settle a claim you had against the trust, your basis for the property is the amount of the settled claim.

If you received a distribution in kind for your share of trust income before June 2, 1984, the basis of the distribution is generally the value of the property to the extent allocated to distributable net income. For distributions in kind after June 1, 1984, in taxable years ending after June 1, 1984, your basis is the basis of the property in the hands of the trust. If the trust elects to treat the distribution as a taxable sale, your basis is generally fair market value.

Property acquired with involuntary conversion proceeds. If you acquire replacement property with insurance proceeds from destroyed property, or a government payment for condemned property, basis is the cost of the new property decreased by deferred gain; *see* ¶18.23 for figuring the deferred gain. If the replacement property consists of more than one piece of property, basis is allocated to each piece in proportion to its respective cost.

EXAMPLE

A building with an adjusted basis of $100,000 is destroyed by fire. The owner receives an insurance award of $200,000, realizing a gain of $100,000. He buys a building as a replacement for $150,000. Of the $100,000 gain, $50,000 is taxable, while the remaining $50,000 is deferred. Taxable gain is limited to the portion of the insurance award not used to buy replacement property ($200,000 – $150,000). The basis of the new building is $100,000:

Cost of the new building	$150,000
Less: deferred gain	50,000
Basis	$100,000

¶5.21 Basis of Property You Inherited or Received as a Gift

Special basis rules apply to property you received as a gift or that you inherited. Gifts from a spouse are subject to the rules of ¶6.6. If you are a surviving joint tenant who received full title to property upon the death of the other joint tenant, *see* ¶5.22.

BASIS OF PROPERTY RECEIVED AS GIFT

If the fair market value of the property *equalled or exceeded* the donor's adjusted basis (¶5.24) at the time you received the gift, your basis for figuring gain or loss when you sell it is the donor's adjusted basis plus all or part of any gift tax paid; *see* the gift tax rule in the next column.

If on the date of the gift, the fair market value was *less* than the donor's adjusted basis, your basis for purposes of figuring *gain* is the donor's adjusted basis, and your basis for figuring *loss* is the fair market value.

EXAMPLES

Assume that in 1986 you received a gift of stock from your father which you sold in 1996. His adjusted basis was $1,000.

The basis you use to determine gain or loss depends on whether the fair market value of the stock on the date of the gift equalled or exceeded your father's $1,000 adjusted basis. If it did, your basis is your father's $1,000 basis and you will realize a gain if your selling price exceeds $1,000, as on Line 1 below, or a loss if the selling price is below $1,000, as on Line 4.

If the value of the stock on the date of the gift was less than $1,000 (father's basis) then you have: a gain if you sell for more than $1,000, as on Line 5; a loss if you sell for less than the $1,000 date-of-gift value, as on Line 2; or neither gain nor loss if you sell for more than the date-of-gift value but no more than $1,000 (father's basis), as on Line 3.

	If value of the gift at receipt was—	And you sold it for—	Your basis is—	Your gain is—	Your loss is—
1.	$3,000	$2,000	$1,000	$1,000	
2.	700	500	700		$200
3.	300	500	*	none	none
4.	1,500	500	1,000		500
5.	500	1,200	1,000	200	

* On Line 3 of the Example, where you sell for more than the date-of-gift value but for no more than the donor's basis, there is neither gain nor loss. To see if you have a *gain*, you use the donor's $1,000 basis as your basis, but on a sale for $500, you have a loss ($500) and not a gain. To see if you have a *loss*, you use the $300 date-of-gift value of the stock as your basis, but on a sale for $500, you have a gain ($200) and not a loss. Thus, you have neither gain nor loss under the basis rules which require you to use the donor's basis for determining if you have a gain, and the date of gift value for determining if you have a loss.

Did the donor pay gift tax? If the donor paid a gift tax (¶33.1) on the gift to you, your basis for the property is increased under these rules:

1. For property received after December 31, 1976, the basis is increased for the gift tax paid by an amount which bears the same ratio to the amount of tax paid as the net appreciation in the value of the gift bears to the amount of the gift after taking into account the $10,000 annual gift tax exclusion (¶33.1). The increase may not exceed the tax paid. Net appreciation in the value of any gift is the amount by which the fair market value of the gift exceeds the donor's adjusted basis immediately before the gift. *See* Example 2 on the next page.
2. For property received after September 1, 1958, but before 1977, basis is increased by the gift tax paid on the property but not above the fair market value of the property at the time of the gift.
3. For property received before September 2, 1958, the gift tax paid increases the basis. But this increase may not be more than the excess of the fair market value of the property at the time of the gift over the basis of the property in the donor's hands. Ask the donor or his or her advisor for these amounts.

EXAMPLES

1. In 1975, your father gave you rental property with a fair market value of $78,000. The basis of the property in his hands was $60,000. He paid a gift tax of $15,000 on the gift. The basis of the property in your hands is $75,000 ($60,000 + $15,000).

2. In 1996, your father gave you rental property with a fair market value of $178,000. His basis in the property was $160,000. He paid a gift tax of $44,560 on a taxable gift of $168,000, after claiming the $10,000 annual exclusion. The basis of the property in your hands is your father's basis increased by the gift tax attributable to the appreciation. Gift tax attributable to the appreciation is:

$$\frac{\text{Appreciation}}{\text{Gift minus annual exclusion}} \times \text{Gift tax paid}$$

$$\frac{\$18{,}000}{\$168{,}000} \times \$44{,}560 = \$4{,}774$$

Your basis for figuring gain or loss or depreciation is $164,774 ($4,774 + $160,000 father's basis).

Gift you received before 1921. Your basis is the fair market value of the property at the time of the gift.

Depreciation on property received as a gift. If the property is depreciable (*see* Chapter 42), your basis for computing depreciation deductions is the donor's adjusted basis (¶5.24), *plus* all or part of the gift tax paid by the donors as previously discussed.

When you sell the property, you must adjust basis (¶5.24) for depreciation claimed. If accelerated depreciation is claimed and you sell at a gain, you are subject to the ordinary income recapture rules discussed at ¶44.1.

If you receive a residence as a gift and later convert it to rental property, *see* ¶29.19.

BASIS OF INHERITED PROPERTY

Your basis for inherited property is generally the fair market value of the property on the date of the decedent's death, regardless of when you acquire the property. If the decedent died after October 21, 1942, and the executor elected to use an *alternate valuation date* after the death, your basis is the alternate value at that date.

If you owned the property jointly with the deceased, *see* ¶5.22.

If you inherit appreciated property that you (or your spouse) gave to the deceased person within one year of his or her death, your basis is the decedent's basis immediately before death, not its fair market value.

If the inherited property is subject to a mortgage, your basis is the value of the property, and not its equity at the date of death. If the property is subject to a lease under which no income is to be received for years, the basis is the value of the property—not the equity.

You might be given the right to buy the deceased person's property under his or her will. This is not the same as inheriting that property. Your basis is what you pay—not what the property is worth on the date of the deceased's death.

If property was inherited from a decedent dying after 1976 and before November 7, 1978, and the executor elected to apply a carryover basis to all estate property, your basis is figured with reference to the decedent's basis. The executor must inform you of the basis of such property.

Advantage of Leaving Appreciated Property to an Heir

Since your basis for inherited property is the value at the decedent's death or alternate valuation date, tax is completely avoided on the appreciation in value that occurred while the decedent owned the property.

Community property. Upon the death of a spouse in a community property state, one-half of the fair market value of the community property is generally included in the deceased spouse's estate for estate tax purposes. The surviving spouse's basis for his or her half of the property is 50% of the total fair market value. For the other half, the heirs of the deceased spouse also have a basis equal to 50% of the fair market value.

¶5.22 Joint Tenancy Basis Rules for Surviving Tenants

For deaths occurring after 1981, the law provides different basis rules for joint tenancies between husbands and wives than for tenancies between persons who are not married to each other.

Survivor of spouse who died after 1981. A "qualified joint interest" rule applies to a joint tenancy with right of survivorship where the spouses are the only joint tenants, and to a tenancy by the entirety between a husband and wife. Where the surviving spouse is a U.S. citizen, the general rule for deaths occurring *after 1981* is as follows: One-half of the fair market value of the property is includable in the decedent's gross estate. This is true regardless of how much each spouse contributed to the purchase price. Fair market value is fixed at the date of death, or six months later if an estate tax return is filed and the optional alternate valuation date is elected.

The surviving spouse's basis equals the one-half estate tax share, plus one-half of the original cost basis for the property; *see* Example 1 below. If no estate tax return was due because the value of the estate was below the filing threshold, the surviving spouse's basis is one-half of the fair market value of the property at the date of death (alternate valuation is not available) plus one-half of the original cost basis. If depreciation deductions for the property were claimed before the date of death, the surviving spouse must reduce basis by his or her share (under local law) of the depreciation; *see* Example 2.

Spousal joint tenancies created before 1977. The below IRS claims that regardless of when the joint tenancy was created, the above 50% estate tax inclusion rule and the 50% stepped-up basis rule apply where the death of the first spouse occurs after 1981. However, a federal appeals court has held that these rules do *not* apply to pre-1977 spousal joint tenancies; *see* Example 3 on the next page.

EXAMPLES

1. John and Jennifer Jones jointly own a house that cost them $50,000 in 1979. John paid $45,000 of the purchase price and Jennifer $5,000. In 1996, John dies when the house is worth $200,000. One-half, or $100,000, is included in his estate although he contributed 90% of the purchase price. For income tax purposes, Jennifer's basis for the house is $125,000.

One-half of cost basis	$25,000
Inherited portion	100,000
Jennifer's basis	$125,000

   On a sale of the home for $200,000, Jennifer would realize a $75,000 long-term capital gain ($200,000 – $125,000).

2. Same facts as in Example 1 except that the home was rental property for which $20,000 of depreciation deductions had been allowed before John's death. Under local law, Jennifer had a right to 50% of the income from the property and, thus, a right to 50% of the depreciation. Her basis for the property is $115,000: $125,000 as shown in Example 1, reduced by $10,000, her share of the depreciation.

3. The Gallensteins purchased farm property in 1955 as joint tenants; Mr. Gallenstein provided all the funds. When he died in 1987, Mrs. Gallenstein claimed that 100% of the property was includible in her husband's gross estate and she had a stepped-up basis for that full amount. The IRS argued that under the rules for estates of spouses dying after 1981, her basis was 50% of the date-of-death value. The federal appeals court for the Sixth Circuit (Kentucky, Michigan, Ohio, and Tennessee) agreed with Mrs. Gallenstein. The appeals court held that pre-1977 spousal joint tenancies were not affected when the law was changed to provide a 50% estate tax inclusion and 50% stepped-up basis for spousal deaths after 1981. For pre-1977 spousal joint tenancies, the prior law rule continues to apply: 100% of the date-of-death value of jointly held property is included in the estate of the first spouse to die unless it is shown that the survivor contributed towards the purchase. Thus, in this case, Mrs. Gallenstein's basis was 100% of the value of the property and she realized no taxable gain when she sold the property at a price equal to that stepped-up basis.

   If the statute of limitations has not expired, a surviving spouse who reported gain on a sale of property using the 50% basis rule should consult with his or her tax adviser about filing a refund claim based upon the 100% basis rule in the Gallenstein case. However, the IRS may reject such refund claims outside the Sixth Circuit.

   Note: At the time this book went to press, the IRS was appealing to the Fourth Circuit Appeals Court a federal district court decision that followed the Sixth Circuit's *Gallenstein* approach of allowing a 100% stepped-up basis for a pre-1977 spousal joint interest.

Unmarried joint tenants. If you are a surviving joint tenant who owned property with someone other than your spouse, your basis for the entire property is your basis for your share before the joint owner died *plus* the fair market value of the decedent's share at death (or on the alternate valuation date if the estate uses the alternate date). Even if the estate is too small to require the filing of an estate tax return, you may still include the decedent's share of the date-of-death value in your basis. However, if no estate tax return is required, you may not use the alternate valuation date basis.

EXAMPLE

You and your sister bought a home in 1950 for $20,000. She paid $12,000, and you paid $8,000. Title to the house was held by both of you as joint tenants. In 1996, when she died, the house was worth $150,000. Since she paid 60% of the cost of the house, 60% of the value at her death, $90,000, is included in her estate tax return (or would be included if an estate tax return was due). Your basis for the house is now $98,000—the $8,000 you originally paid *plus* the $90,000 fair market value of your sister's share at her death.

Exception for pre-1954 deaths. Where property was held in joint tenancy and one of the tenants died before January 1, 1954, no part of the interest of the surviving tenant is treated, for purposes of determining the basis of the property, as property transmitted at death. The survivor's basis is the original cost of the property.

Survivor of spouse who died before 1982. The basis rule for a surviving spouse who held property jointly (or as tenancy by the entirety) with a spouse who died before 1982 is generally the same as the above rule for unmarried joint tenants. However, special rules applied to qualified joint interests and eligible joint interests are discussed below.

EXAMPLE

A husband and wife owned rental property as tenants by the entirety that they purchased for $30,000. The husband furnished two-thirds of the purchase price ($20,000) and the wife furnished one-third ($10,000). Depreciation deductions taken before the husband's death were $12,000. On the date of his death in 1979, the property had a fair market value of $60,000. Under the law of the state in which the property is located, as tenants by the entirety, each had a half interest in the property. The wife's basis in the property at the date of her husband's death is $44,000, computed as follows:

Interest acquired with her own funds	$10,000
Interest acquired from husband (⅔ of $60,000)	40,000
	$50,000
Less: Depreciation of ½ interest not acquired by reason of death (½ of $12,000)	6,000
Wife's basis at date of husband's death	$44,000

If she had not contributed any part of the purchase price, her basis at the date of her husband's death would be $54,000 ($60,000 fair market value *less* $6,000 depreciation).

Qualified joint interest and eligible joint interest where spouse died before 1982. Where, after 1976, a spouse dying before 1982 elected to treat realty as a "qualified joint interest" subject to gift tax, such joint property was treated as owned 50–50 by each spouse, and 50% of the value was included in the decedent's estate. Thus, for income tax purposes, the survivor's basis for the inherited 50% half of the property is the estate tax value; the basis for the other half is determined under the gift rules detailed in ¶5.21. Personal property is treated as a "qualified joint interest" only if it was created or deemed to have been created after 1976 by a husband and wife and was subject to gift tax.

Where death occurred before 1982 and a surviving spouse materially participated in the operation of a farm or other business, an estate may elect to treat the farm or business property as an "eligible joint interest," which means that part of the investment in the property may be attributed to the surviving spouse's services and that part is not included in the deceased spouse's estate. Where such an election was made, the survivor's basis for income tax purposes includes the estate tax value of property included in the decedent's estate.

¶5.23 When To Allocate Cost

Allocation of basis is generally required in these cases: when the property includes land and building; the land is to be divided into lots; securities are purchased at different times; stock splits; and in the purchase of a business.

Purchase of land and building. To figure depreciation on the building, part of the purchase price must be allocated to the building. The allocation is made according to the fair market values of the building and land. The amount allocated to land is not depreciated.

Purchase of land to be divided into lots. The purchase price of the tract is allocated to each lot, so that the gain or loss from the sale of each lot may be reported in the year of its sale. Allocation is not made ratably, that is, with an equal share to each lot or parcel. It is based on the relative value of each piece of property. Comparable sales, competent appraisals, or assessed values may be used as guides.

Securities. *See* ¶30.3 for details on methods of identifying securities bought at different dates.

See ¶30.4 for allocating basis of stock dividends and stock splits and ¶30.5 for allocating the basis of stock rights.

Purchase price of a business. *See* ¶44.9 for allocation rule.

¶5.24 How To Find Adjusted Basis

After determining the *unadjusted* cost basis for property under the rules at ¶¶5.20–5.23, you may have to increase it or decrease it to find your *adjusted basis*, which is the amount used to figure your gain or loss on a sale, as shown at ¶5.17.

1. Additions to basis. You add to unadjusted basis the cost of these items—

All permanent improvements and additions to the property and other capital costs, such as the cost of repairing your property after a casualty (for example, repair costs after a fire or storm).

Legal fees, including fees incurred for defending or perfecting title, or for obtaining a reduction of an assessment levied against property to pay for local benefits.

Sale of unharvested land. If you sell land with unharvested crops, add the cost of producing the crops to the basis of the property sold.

2. Deductions from basis. You reduce cost basis for these items—

Return of capital, such as dividends on stock paid out of capital or out of a depletion reserve when the company has no available earnings or surplus; *see* ¶4.11.

Losses from casualties, including insurance awards and payments in settlement of damages to your property.

EXAMPLE

Your house, which cost $75,000, is damaged by fire. You deducted the uninsured loss of $10,000 and spent $11,000 to repair the property. Several years later, you sell the house for $90,000. To figure your profit, increase the original cost of the house by the $11,000 of repairs and then reduce basis by the $10,000 casualty loss to get an adjusted basis of $76,000 ($75,000 + $11,000 – $10,000). Your gain on the sale is $14,000 ($90,000 – $76,000).

Depletion allowances; *see* ¶9.15.

Depreciation, first-year expensing deduction, ACRS deductions, amortization, and obsolescence on property used in business or for the production of income. In some years, you may have taken more or less depreciation than was allowable.

If you claim less than what was allowable, you must deduct from basis the allowable amount rather than what was actually claimed. You may file an amended return to claim the full allowable depreciation for a year (¶38.1). If the amended return deadline has passed, you may still get a deduction for the unclaimed depreciation by filing for an accounting method change under IRS Revenue Procedure 96-31; a deduction for the entire amount is allowed for the year of the accounting change.

If you took more depreciation than was allowable, you may have to make the following adjustments: If you have deducted more than what was allowable and you received a tax benefit from the deduction, you deduct from basis the full amount of the depreciation. But if the excess depreciation did not give you a tax benefit, because income was eliminated by other deductions, the excess is not deducted from basis. These rules affect all tax years after 1951.

Amortized bond premium; *see* ¶4.17.

Cancelled debt excluded from income. If you did not pay tax on certain cancellations of debt because of bankruptcy or insolvency, or on qualifying farm debt or business real property, you reduce basis of your property for the amount forgiven under the rules at ¶12.9 and ¶12.10.

Investment credit. Where the full investment credit was claimed in 1983 or later years, basis was reduced by one-half the credit.

Reporting an Installment Sale

¶5.25 Tax Advantage of Installment Sales

If you sell property at a *gain* in 1996 and you will receive one or more payments in a later year or years, you may use the installment method to defer tax unless the property is publicly traded securities or you are a dealer of the property sold. If you report the sale as an installment sale on Form 6252, your profit is taxed as installments are received. You may elect *not* to use the installment method if you want to report the entire profit in the year of sale; *see* Example 1 in the next column and ¶5.27.

Losses may not be deferred under the installment method.

How the installment method works. For each year you receive installment payments, report your gain on Form 6252. Installment income from the sale of a capital asset is then transferred to Schedule D. If your gain in the year of sale is long-term capital gain, gain in later years is also long term; short-term treatment in the year of sale applies also to later years. Interest payments you receive on the deferred sale are reported with your other interest income on Schedule B of Form 1040.

Installment income from the sale of business or rental property is figured on Form 6252 and then entered on Form 4797. If you make an installment sale of depreciable property, any *depreciation recapture* (¶44.1) is reported as income in the year of disposition. The recaptured amount is first figured on Form 4797 and then entered on Form 6252. On Form 6252, recaptured income is added to basis of the property for purposes of figuring the gross profit ratio for the balance of gain to be reported, if any, over the installment period; *see also* ¶44.7.

Installment sales of business or rental property for over $150,000 may be subject to a special tax if deferred payments exceed $5 million; *see* ¶5.35.

EXAMPLES

1. In 1996, you sell real estate for $100,000 that you bought in 1985 for $44,000. Selling expenses were $6,000. You are to receive $20,000 in 1996, 1997, and 1998; and $40,000 in 1999, plus interest of 9% compounded semiannually. Your gross profit is $50,000 ($100,000 contract price less $44,000 cost and $6,000 selling expenses). For installment sale purposes, your gross profit percentage, which is the percentage of each payment that you must report, is 50% ($50,000 profit ÷ $100,000 contract price). When the buyer pays the notes, you report the following:

	You report	
In	Payment of:	Income of:
1996	$20,000	$10,000
1997	20,000	10,000
1998	20,000	10,000
1999	40,000	20,000
Total	$100,000	$50,000

   In 1996, you file Form 6252 to figure your gross profit and gross profit percentage. You report only $10,000 as profit on Schedule D (or Form 4797, if applicable). If you do not want to use the installment method, you make an election by reporting the entire gain of $50,000 on Schedule D or Form 4797.

2. On December 21, 1996, you sell a building for $150,000, realizing a profit of $25,000. You take a note payable in January 1997. You report the gain in 1997. Receiving a lump-sum payment in a taxable year after the year of sale is considered an installment sale.

Year-end sales of publicly traded stock or securities. You have no choice about when to report the gain from a sale of publicly traded stock or securities made at the end of 1996. Any gain must be reported in 1996, even if the proceeds are not received until early 1997. The sale is not considered an installment sale.

Farm property. A farmer may use the installment method to report gain from the sale of property that does not have to be inventoried under his method of accounting. This is true even though such property is held for regular sale.

Dealer sales. Generally, dealers must report gain in the year of sale for personal property regularly sold on an installment plan, or real estate held for resale to customers. However, the installment method may be used by dealers of certain time shares (generally time shares of up to six weeks per year) and residential lots, but only if an election is made to pay interest on the tax deferred by using the installment method. For further details, *see* the instructions to Schedule C of Form 1040.

¶5.26 Figuring the Taxable Part of Installment Payments

On the installment method, a portion of each payment other than interest represents part of your gain and is taxable. This taxable amount is based on the gross profit percentage or ratio, which is figured by dividing gross profit by the selling price or the contract price. The contract price is the same as the selling price unless an adjustment is made for an existing mortgage assumed or "taken subject to" by the buyer. The term *contract price* is used in the computation to describe only payments which the seller receives or is considered to have received. Thus, it does not include the buyer's assumption of an existing mortgage; *see* the next column for the mortgage adjustment to contract price. By following the line-by-line instructions to Form 6252, you get the gross profit percentage. Selling price, contract price, and gross profit are explained in the following paragraphs.

Interest equal to the *lesser* of 100% of the applicable federal rate and 9% compounded semiannually must generally be charged on a deferred payment sale. Otherwise, the IRS treats part of the sale price as interest; *see* ¶4.32.

EXAMPLE

On December 7, 1996, you sell real estate for $100,000. The property had an adjusted basis of $56,000. Selling expenses are $4,000. You are to receive installment payments of $25,000 in 1996, 1997, 1998, and 1999, plus interest at 9%, compounded semiannually. The gross profit percentage of 40% is figured as follows:

Selling price (contract price)	$100,000
Less: Adjusted basis and selling expenses	60,000
Gross profit	$ 40,000

$$\frac{\text{Gross profit}}{\text{Contract price}} = \frac{\$40{,}000}{\$100{,}000} = 40\% \text{ (gross profit percentage)}$$

In 1996, you report a profit of $10,000 (40% of $25,000) on Form 6252. Similarly, in each of the following three years, a profit of $10,000 is reported so that by the end of four years, the entire $40,000 profit will have been reported.

Selling price. Include cash, fair market value of property received from the buyer, the buyer's notes (at face value), and any outstanding mortgage on the property that the buyer assumes or takes subject to. If, under the contract of sale, the buyer pays off an existing mortgage or assumes liability for any other liens on the property, such as taxes you owe, or pays the sales commissions, such payments are also included in the selling price.

Interest, including interest imputed under the rules of ¶4.32, is not included in the selling price.

Notes of a third party given to you by the buyer are valued at fair market value.

Gross profit and gross profit percentage. Gross profit is the selling price *less* the adjusted basis of the property (¶5.24), *plus* selling expenses, such as brokers' commissions and legal fees, and recaptured depreciation income, if any (¶44.1).

Divide the gross profit by the selling or contract price to get the gross profit percentage. Each year, you multiply this percentage by your payments to determine the taxable amount under the installment method.

Contract price where the buyer takes subject to or assumes an existing mortgage. To figure the gross profit percentage first reduce the selling price by the amount of the mortgage. The reduced amount is the *contract price.* You then divide your gross profit by the *contract* price to get the gross profit percentage.

If the mortgage exceeds the adjusted basis of the property plus selling expenses and depreciation recapture, you are required to report the excess as a payment received in the year of sale and thus may increase the *contract price* by that excess amount. Where the mortgage equals or exceeds basis plus selling expenses and depreciation recapture, the gross profit percentage will be 100%; *see* Example 3 below.

In a wraparound mortgage transaction, the buyer's payments reflect the amounts that the seller needs to meet his mortgage liability. At one time, the IRS treated a wraparound mortgage transaction as an assumption of a mortgage by the buyer and required a reduction of the selling price by the mortgage. The Tax Court rejected the IRS position, and the IRS acquiesced in the decision. When this book went to press, the IRS had not dropped a temporary regulation requiring the reduction. However, IRS Publication 537 follows the Tax Court view and does not require a reduction of selling price for a wraparound mortgage; *see* Example 5 on the next page.

EXAMPLES

1. You sell a building for $300,000. The building was secured by an existing mortgage of $50,000 which you pay off at the sale closing from the buyer's initial payment. The contract price is $300,000.
2. Same facts as in Example 1, but the buyer assumes the mortgage of $50,000. The contract price is $250,000 ($300,000 – $50,000).
3. You sell a building for $90,000. The buyer will pay you $10,000 annually for three years and assume an existing mortgage of $60,000. The adjusted basis of the property is $45,000. Selling expenses are $5,000. The total installment sale basis is $50,000 ($45,000 plus $5,000). The mortgage exceeds this basis by $10,000 ($60,000 – $50,000). This $10,000 excess is included in the contract price and treated as a payment made in the year of sale. The contract price is $40,000:

Selling price	$90,000
Less: Mortgage	60,000
	$30,000
Add: Excess	10,000
Contract price	$40,000
Selling price	$90,000
Less: Installment sale basis	50,000
Gross Profit	$40,000
Gross profit percentage ($40,000 gross profit ÷ $40,000 contract price)	100%

4. You sell a building for $300,000. The buyer gives you $50,000 in the year of sale; the balance is secured by a purchase money mortgage payable by the buyer to you. The contract price is $300,000.
5. Abel sells real property worth $2 million, encumbered by a mortgage of $900,000. Adjusted basis plus selling costs is $700,000. The buyer pays $200,000 cash and gives an interest-bearing wraparound mortgage note for $1.8 million. Abel remains obligated to pay off the $900,000 mortgage. The gross profit ratio is 65% ($1,300,000 gross profit ÷ $2,000,000 contract price). In the year of sale, Abel reports the $200,000 cash of which 65% of $200,000, or $130,000, is taxable income.

Change of selling price. If the selling price is changed during the period payments are outstanding, the gross profit percentage is refigured on the new selling price. The adjusted profit ratio is then applied to payments received after the adjustment.

EXAMPLE

Jones sold real estate in 1993 for $100,000. His basis, including selling expenses, was $40,000, so his gross profit was $60,000. The buyer agreed to pay, starting in 1994, five annual installments of $20,000 plus 10% interest. As the gross profit percentage was 60% ($60,000 ÷ $100,000), Jones reported profit of $12,000 (60% of $20,000) on the installments received in 1994 and 1995.

In 1996, the parties renegotiated the sales price, reducing it from $100,000 to $85,000, and reducing payments for 1996, 1997, and 1998 to $15,000. Jones's original profit of $60,000 is reduced to $45,000 ($85,000 revised sales price *less* $40,000 basis). Of the $45,000 profit, $12,000 was reported in 1994 and an additional $12,000 in 1995. To get the revised profit percentage, Jones must divide the $21,000 of profit not yet received by the remaining sales price of $45,000 ($85,000 less $40,000 installments in 1994 and 1995). The revised profit percentage is 46.67% ($21,000 ÷ $45,000). In 1996, 1997, and 1998, Jones reports profit of $7,000 on each $15,000 installment (46.67% of $15,000).

Payments received. Payments include cash, the fair market value of property, and payments on the buyer's notes. Payments do not include receipt of the buyer's notes or other evidence of indebtedness, unless payable on demand or readily tradable. "Readily tradable" means registered bonds, bonds with coupons attached, debentures, and other evidences of indebtedness of the buyer that are readily tradable in an established securities market. This rule is directed mainly at corporate acquisitions. A third-party guarantee (including a standby letter of credit) is not treated as a payment received on an installment obligation.

If the buyer has assumed or taken property subject to a mortgage that exceeds your installment sale basis (adjusted basis *plus* selling expenses *plus* depreciation recapture, if any), you include as a payment in the year of the sale the excess of the mortgage over the installment basis; *see* the Johnson Example below.

EXAMPLE

Johnson sells a building for $160,000, subject to a mortgage of $60,000. Installments plus interest are to be paid over five years. His adjusted basis in the building was $30,000 and his selling expenses were $10,000, so his installment sale basis is $40,000 and his gross profit is $120,000 ($160,000 – $40,000). The contract price is also $120,000, the selling price of $160,000 less $40,000, the part of the mortgage that did not exceed the installment sale basis.

The $20,000 difference between the $60,000 mortgage and the installment sale basis of $40,000 is part of the contract price and is also treated as a payment received in the year of sale. Since the mortgage exceeds Johnson's installment sale basis, he is treated as having recovered his entire basis in the year of sale, and all installment payments will be taxable, as his gross profit ratio is 100%: gross profit of $120,000 ÷ contract price of $120,000. In the year of sale, Johnson must report as taxable gain 100% of the installment payment received, plus the $20,000 difference between the mortgage and his installment sale basis.

Pledging installment obligation as security. If, as security for a loan, you pledge an installment obligation from a sale of property of more than $150,000 (excluding farm or personal-use property), the net loan proceeds must be treated as a payment on the installment obligation. The net loan proceeds are treated as received on the later of the date the loan is secured and the date you receive the loan proceeds. These pledging rules do not apply if the debt refinances a debt that was outstanding on December 17, 1987, and secured by the installment obligation until the refinancing. If the refinancing exceeds the loan principal owed immediately before the refinancing, the excess is treated as a payment on the installment obligation. *See* the Form 6252 instructions.

Sale of depreciable property. For the effect of recapture, *see* ¶5.25 and ¶44.7.

Recapture of first-year expensing deduction. The entire recaptured amount under ¶44.3 is reported in the year of sale, even though you report the sale on the installment basis. An installment sale does not defer the reporting of the recaptured deduction. You also add the recaptured amount to the basis of the sold asset to compute the amount of the remaining gain to be reported on each installment. *See* the instructions to Form 6252.

¶5.27 Electing Not To Report on the Installment Method

If any sale proceeds are to be received after the year of sale, you must file Form 6252 and use the installment method unless you "elect out" by making a timely election to report the entire gain in the year of sale. If you want to report the entire gain in the year of sale, include it on Schedule D or Form 4797 by the due date for filing your return (plus extensions) for the year of sale. Do not use Form 6252. After the due date (plus extensions), a change from the installment method to full reporting in the year of sale may be made only with IRS consent. The IRS will give consent only in rare cases where it finds "good cause." The IRS may give consent if your tax preparer erroneously reported on the installment method and you promptly ask IRS permission to change to reporting of the entire gain. A change in the tax law is not considered "good cause" by the IRS. For example, sellers who before 1986 reported on the installment basis on the assumption that their payments would be taxed at favorable capital gain rates, wanted to amend their returns and report the entire gain in the year of sale after the 1986 Tax Act repealed the capital gain exclusion. The IRS would not allow the change.

"Electing Out" of Installment Reporting

When you have losses to offset your gain in the year of sale, installment sale reporting may not be advantageous. In such a case, you may want to report the full gain in the year of sale so the gain may be offset by the losses. However, there is a risk. If the losses are later disallowed by an IRS audit, you may not be given a second chance to use the installment method to spread the gain over the payment period.

For example, a seller "elected out" in a year in which he planned to deduct a net operating loss carryforward from an installment sale gain. In a later year, the IRS substantially reduced the loss. The seller then asked the IRS to allow him to revoke the "election out" so he could use the installment method. The IRS refused, claiming that the seller asked for the revocation to avoid tax. The installment sale would defer gain to a later year, which is a tax avoidance purpose.

Switching from full reporting to installment method. If you do report the entire gain in the year of sale, you may change to the installment method on an amended return only with the consent of the IRS. In a private ruling, the IRS refused to allow a seller to use the installment method after inadvertently including the entire gain from the sale on his return. Although reporting of the entire gain was a mistake, this was treated as an election not to use the installment method. The IRS refused permission to revoke the election on the grounds that a second chance to apply the installment method would be tax avoidance. However, in other private rulings, permission to revoke was granted where the seller's accountant erroneously reported the entire gain.

¶5.28 Restriction on Installment Sales to Relatives

The installment sale method is not allowed where you sell depreciable property to a controlled business, or to a trust in which you or your spouse is a beneficiary.

Further, if you sell property to a relative on the installment basis, and the relative later resells the property, you could lose the benefit of installment reporting. The restrictions on sales to relatives are primarily aimed at the following types of transactions:

1. A buyer insists on paying cash, but the seller who wants the tax deferment advantage of installment reporting arranges an installment sale with a family member who then resells the property for cash to the buyer. If the family member's resale is within two years of the original sale, the original seller is taxed on that sale under the two-year rule discussed on the next page.
2. Securities traded on the exchange cannot be sold on the exchange on the installment basis. To get installment basis reporting, an investor would sell to a related party on the installment basis, and the related party would then sell the securities on the exchange. However, the restrictive rule requires the original investor to report tax on the related party's later sale on the exchange.

EXAMPLE

In 1996, Jones sells stock to his son for $25,000, realizing a profit of $10,000. The son agrees to pay in five annual installments of $5,000 starting in 1997. Later in 1996, the son sells the stock to a third party for $26,000. Jones Sr. reports his profit of $10,000 in 1996, even though he received no payment that year. Payments received by Jones Sr. from his son after 1996 are tax free because he reported the entire profit in 1996.

Two-year rule for property other than marketable securities. If you make an installment sale to a related party of property other than marketable securities, you are taxed on a second sale by the related party only if it occurs within two years of the initial installment sale and before all payments from the first installment sale are made. Related parties include a spouse, child, grandchild, parent, grandparent, brother or sister, controlled corporation (50% or more direct or indirect ownership), any S corporation in which you own stock or partnership in which you are a partner, a trust in which you are a beneficiary, or a grantor trust of which you are treated as the owner. You are treated as owning stock held by your spouse, brothers, sisters, children, grandchildren, parents, and grandparents.

You must report as additional installment sale income: (1) the proceeds from the related party's sale or the contract price from the initial installment sale, whichever is less, minus (2) installment payments received from the related party as of the end of the year. The computation is made in Part III of Form 6252.

The two-year period is extended during any period in which the buyer's risk is lessened by a put on the property, an option by another person to acquire the property, or a short sale or other transaction lessening the risk of loss.

The two-year cutoff does not apply to the sale of marketable securities. For such marketable securities, you can be taxed on any related party's sale occurring before you receive all the payments under the initial installment sale.

Marketable securities are:

1. Securities listed on the New York Stock Exchange, the American Stock Exchange, or any city or regional exchange in which quotations appear on a daily basis, including foreign securities listed on a recognized foreign, national, or regional exchange;
2. Securities regularly traded in the national or regional over-the-counter market, for which published quotations are available;
3. Securities locally traded for which quotations can readily be obtained from established brokerage firms;
4. Units in a common trust fund; and
5. Mutual fund shares for which redemption prices are published.

Exceptions to two-year rule. There are exceptions to this related-party rule. Second dispositions resulting from an involuntary conversion of the property will not be subject to the related-party rule so long as the first disposition occurred before the threat or imminence of conversion. Similarly, transfers after the death of the person making the first disposition or the death of the person acquiring the property in the first disposition are not treated as second dispositions. Also, a sale or exchange of stock to the issuing corporation is not treated as a first disposition. Finally, you may avoid tax on a related party's second sale by satisfying the IRS that neither the initial nor the second sale was made for tax avoidance purposes.

Where you transfer property to a related party, the IRS has two years from the date you notify it that there has been a second disposition to assess a deficiency with respect to your transfer.

Sales of depreciable property to related party. Installment reporting is not allowed for sales of depreciable property made to a controlled corporation or partnership (50% control by seller) and between such controlled corporations and partnerships. In figuring control of a corporation, you are considered to own stock held by your spouse, children, grandchildren, brothers or sisters, parents, and grandparents. Installment reporting is also disallowed on a sale to a trust in which you or a spouse is a beneficiary unless your interest is considered a remote contingent interest whose actuarial value is 5% or less of the trust property's value. On these related-party sales, the entire gain is reported in the year of sale, unless the seller convinces the IRS that the transfer was not motivated by tax avoidance purposes.

On a sale of depreciable property to a related party, if the amounts of payments are contingent (for example, payments are tied to profits), the seller must make a special calculation. He or she must treat as received in the year of sale all noncontingent payments plus the fair market value of the contingent payments if such value may be reasonably ascertained. If the fair market value of the contingent payments may not be reasonably calculated, the seller recovers basis ratably. The purchaser's basis for the acquired property includes only amounts that the seller has included in income under the basis recovery rule. Thus, the purchaser's basis is increased annually as the seller recovers basis.

¶5.29 Contingent Payment Sales

Where the final selling price or payment period of an installment sale is not fixed at the end of the taxable year of sale, you are considered to have transacted a "contingent payment sale." Special rules apply where a maximum selling price may be figured under the terms of the agreement or there is no fixed price but there is a fixed payment period, or there is neither a fixed price nor a fixed payment period.

Stated maximum selling price. Under IRS regulations, a stated maximum selling price may be determined by assuming that all of the contingencies contemplated under the agreement are met. When the maximum amount is later reduced, the gross profit ratio is recomputed.

EXAMPLE

Smith sells stock in Acme Co. for a down payment of $100,000 plus an amount equal to 5% of the net profits of Acme for the next nine years. The contract provides that the maximum amount payable, including the $100,000 down payment but exclusive of interest, is $2,000,000. Smith's basis for the stock is $200,000; $2,000,000 is the selling price and contract price. Gross profit is $1,800,000. The gross profit ratio is 90% ($1,800,000 ÷ $2,000,000). Thus, $90,000 of the first payment is reportable as gain and $10,000 as a recovery of basis.

Fixed period. When a stated maximum selling price is not determinable but the maximum payment period is fixed, basis—including selling expenses—is allocated equally to the taxable years in which payment may be received under the agreement. If, in any year, no payment is received or the amount of payment received is less than the basis allocated to that taxable year, no loss is allowed unless the taxable year is the final payment year or the agreement has become worthless. When no loss is allowed in a year, the basis allocated to the taxable year is carried forward to the next succeeding taxable year.

EXAMPLE

Brown sells property for 10% of the property's gross rents over a five-year period. Brown's basis is $5,000,000. The sales price is indefinite and the maximum selling price is not fixed under the terms of the contract; basis is recovered ratably over the five-year period.

Year	*Payment*	*Basis recovered*	*Gain*
First	$1,300,000	$1,000,000	$300,000
Second	1,500,000	1,000,000	500,000

Year	Payment	Basis recovered	Gain
Third	1,400,000	1,000,000	400,000
Fourth	1,800,000	1,000,000	800,000
Fifth	2,100,000	1,000,000	1,100,000

No stated maximum selling price or fixed period. If the agreement fails to specify a maximum selling price and payment period, the IRS may view the agreement as a rent or royalty income agreement. However, if the arrangement qualifies as a sale, basis (including selling expenses) is recovered in equal annual increments over a 15-year period commencing with the date of sale. If in any taxable year no payment is received or the amount of payment received (exclusive of interest) is less than basis allocated to the year, no loss is allowed unless the agreement has become worthless. Excess basis not recovered in one year is reallocated in level amounts over the balance of the 15-year term. Any basis not recovered at the end of the 15th year is carried forward to the next succeeding year, and to the extent unrecovered, carried forward from year to year until basis has been recovered or the agreement is determined to be worthless. The rule requiring initial level allocation of basis over 15 years may not apply if you prove to the IRS that a 15-year general rule will substantially and inappropriately defer recovery of basis.

In some cases, basis recovery under an income forecast type of method may also be allowed.

An installment sale with payments to be made in foreign currency or tangible payment units (such as bushels of wheat) is a contingent payment sale, but basis is allocated as if payment were fixed in U.S. dollars.

EXAMPLE

In 1995, Jones sells property for 10,000 English pounds. In 1996, 2,500 pounds are payable. In 1997, the balance of 7,500 pounds is payable. Basis in the property is $2,000. In 1996, 25% of the basis, or $500 (25% of $2,000), is allocated to the first payment. In 1997, $1,500 (75% of $2,000) is allocated to the second payment.

¶5.30 Using Escrow and Other Security Arrangements

You sell property and the sales proceeds are placed in escrow pending the possible occurrence of an event such as the approval of title or your performance of certain contractual conditions. The IRS may argue that installment reporting is not allowed unless there are escrow restrictions preventing immediate payment.

EXAMPLE

Anderson sold stock and mining property for almost $5 million. He agreed to place $500,000 in escrow to protect the buyer against his possible breaches of warranty and to provide security for certain liabilities. The escrow agreement called for Anderson to direct the investments of the escrow fund and receive income from the fund in excess of $500,000.

The IRS claimed that in the year of sale Anderson was taxable on the $500,000 held in escrow on the ground that Anderson's control of the fund rendered the fund taxable immediately. Anderson argued he was only taxable as the funds were released to him, and the Tax Court agreed. The fund was not under his unqualified control. He might never get the fund if the liabilities materialized. Although Anderson had a free hand with investment of the money, he still lacked ultimate ownership.

COURT DECISION

Tax on Escrow Fund

The escrow agreement may authorize you to receive the income it produces or it may even authorize you to control the manner in which the fund is to be invested. As in the previous Example, these facts do not make the fund taxable to you before the year you actually have it, assuming the escrow restricts immediate payment to you in order to protect the buyer. You are, of course, taxable on the income earned by the fund when you receive the income.

If the terms of the escrow involve no genuine conditions that prevent you from demanding immediate payment, there will be immediate tax.

EXAMPLE

Rhodes sold a tract to a buyer who was willing to pay at once the entire purchase price of $157,000. But Rhodes wanted to report the sale on the installment basis over a period of years. The buyer refused to execute a purchase money mortgage on the property to allow the installment sale election (required under prior law) because he wanted clear and unencumbered title to the tract. As a solution, Rhodes asked the buyer to turn over the purchase price to a bank, as escrow agent, which would pay the sum over a five-year period.

The escrow arrangement failed to support an installment sale. Rhodes was fully taxable on the entire price in the year of the sale. The buyer's payment was unconditional and irrevocable. The escrow arrangement involved no genuine conditions that could defeat Rhodes's right to payment, as the buyer could not revoke, alter, or end the arrangement.

Substitution of an escrow account for unpaid notes or deeds of trust disqualifies installment reporting.

EXAMPLE

In January, an investor sold real estate for $100,000. He received $10,000 as a down payment and six notes, each for $15,000, secured by a deed of trust on the property. The notes, together with interest, were due annually over the next six years. In July, the buyer deposited the remainder of the purchase price with an escrow agent and got the seller to cancel the deed of trust.

The agreement provides that the escrow agent will pay off the buyer's notes as they fall due. The buyer remains liable for the installment payments. The escrow deposit is irrevocable, and the payment schedule may not be accelerated by any party under any circumstances. According to the IRS, the sale, which initially qualified as an installment sale, is disqualified by the escrow account.

Installment Reporting on Escrow Allowable

If an escrow arrangement imposes a substantial restriction, the IRS may allow installment reporting. An example of a substantial restriction: Payment of the escrow is tied to the condition that the seller refrain from entering a competing business for a period of five years. If, at any time during the escrow period, he or she engaged in a competing business, all rights to the amount then held in escrow would be forfeited.

¶5.31 Minimum Interest on Deferred Payment Sales

The tax law requires a minimum amount of interest to be charged on deferred payment sales. The rules for imputing interest are discussed at ¶4.32. Imputed interest is included in the taxable income of the seller. Imputed interest is deductible by the buyer if the property is business or investment property, but not if it is used substantially all the time for personal purposes.

¶5.32 Dispositions of Installment Notes

A sale, a gift, an exchange or other transfer or cancellation of mortgage notes or other obligations received in an installment sale has tax consequences. If you sell or exchange the notes or if you accept less than face value in satisfaction of the obligation, gain or loss results to the extent of the difference between the basis of the notes and the amount realized. For example, if in satisfaction of an installment note, the buyer gives you other property worth less than the face value of the note, you have gain (or loss) to the extent your amount realized exceeds (or is less than) your *basis* in the installment note. The basis of an installment note or obligation is the face value of the note *less* the income that would be reported if the obligation were paid in full; *see* Example 2 below.

Gain or loss is long term if the original sale was entitled to long-term capital gain treatment. This is true even if the notes were held short term. If the original sale resulted in short-term gain or ordinary income, the sale of the notes gives short-term gain or ordinary income, regardless of the holding period of the notes.

EXAMPLES

1. You sell a lot for $20,000 which cost you $10,000. In the year of the sale, you received $5,000 in cash and the purchaser's notes for the remainder of the selling price, or $15,000. A year later, before the buyer makes a payment on the notes, you sell them for $13,000 cash:

Selling price of property	$20,000
Cost of property	10,000
Total profit	$10,000
Profit percentage, or proportion of each payment returnable as income, is 50% ($10,000 total profit ÷ $20,000 contract price)	
Unpaid balance of notes	$15,000
Amount of income reportable if notes were paid in full (50% of $15,000)	7,500
Adjusted basis of the notes	$7,500

Your profit on the sale is $5,500 ($13,000 – $7,500). It is capital gain if the sale of the lot was taxable as capital gain.

2. You sell a lot on the installment basis for $200,000 which cost you $120,000. In the year of sale, you received $20,000 in cash and the buyer's note for $180,000. Your gross profit percentage is 40% ($80,000 total profit ÷ $200,000 contract price).

Two years later, the buyer is facing financial difficulties and is unable to make payments on the $180,000 note. In satisfaction of the installment note, the buyer agrees to give you two other parcels of real estate, each worth $50,000. By accepting less than the $180,000 face value of the note in satisfaction of the obligation, you realize an $8,000 capital loss; the difference between the amount you realize and your basis in the installment obligation is figured as follows:

Amount realized ($50,000 for each parcel)	$100,000
Face value of note	180,000
Less: Amount of income reportable if note was paid in full given 40% profit percentage (40% of $180,000 = $72,000)	72,000
Basis in installment note	$108,000

The difference between the $100,000 amount realized and $108,000 basis gives you an $8,000 loss. Assuming your profit on the original sale was long-term capital gain, the loss would be deducted as a long-term capital loss.

Suppose you make an installment sale of your real estate, taking back a land contract. Later a mortgage is substituted for the unpaid balance of the land contract. The IRS has ruled that the substitution is not the same as a disposition of the unpaid installment obligations. There is no tax on the substitution.

If the installment obligations are disposed of other than by sale or exchange, such as when you make a gift of the installment obligations to someone else, gain or loss is the difference between the basis of the obligations and their fair market value at the time of the disposition. If an installment obligation is *cancelled* or otherwise becomes unenforceable, the same rule for determining gain or loss applies.

A gift of installment obligations to a person or charitable organization is treated as a taxable disposition. Gain or loss is the difference between the basis of the obligations and their fair market value at the time of the gift. If the notes are donated to a qualified charity, you may claim a contribution deduction for the fair market value of the obligations at the time of the gift.

Not all dispositions of installment obligations result in recognition of gain or loss. A transfer of installment obligations to your spouse or a transfer to a former spouse that is incident to a divorce is treated as a tax-free exchange under the rules of ¶6.6 unless the transfer is in trust. A transfer of installment obligations at death is not taxed. As the notes are paid, the estate or beneficiaries report income in the same proportion as the decedent would have, had he or she lived. A transfer of installment obligations to a revocable trust is also not taxed.

¶5.33 Repossession of Personal Property Sold on Installment

When a buyer defaults and you repossess personal property, either by a voluntary surrender or a foreclosure, you may realize gain or loss. The method of calculating gain or loss is similar to the method used for disposition of installment notes; *see* ¶5.32. Gain or loss is the difference between the fair market value of the repossessed property and your basis for the installment obligations satisfied by the repossession. This rule is followed whether or not title has been kept by you or transferred to the buyer. The amount realized is reduced by costs incurred during the repossession. The basis of the obligation is face value less unreported profit.

If the property repossessed is bid in at a lawful public auction or judicial sale, the fair market value of the property is presumed to be the purchase or bid price, in the absence of proof to the contrary.

Gain or loss in the repossession is reported in the year of the repossession.

EXAMPLE

In December 1995, you sell furniture for $1,500—$300 down and $100 a month plus 9% interest beginning January 1996. You reported the installment sale on your 1995 tax return. The buyer defaulted after making three monthly payments. You foreclosed and repossessed the property; the fair market value was $1,400. The legal costs of foreclosure were $100. The gain on the repossession in 1996 is computed as follows:

Fair market value of property repossessed		$1,400
Basis of the buyer's notes at time of repossession:		
Selling price	$1,500	
Less: Payments made	600	
Face value of notes at repossession	$ 900	
Less: Unrealized profit (assume gross profit percentage of 33⅓ × $900)	$ 300	
	$ 600	600
Gain on repossession		$ 800
Less: Repossession costs		100
Taxable gain on repossession		$ 700

Repossession gain or loss keeps the same character as the gain or loss realized on the original sale. If the sale originally resulted in a capital gain, the repossession gain is also a capital gain.

Your basis in the repossessed property is its fair market value at the time of repossession.

Real property. Repossessions of real property are at ¶31.13.

¶5.34 Boot in Like-Kind Exchange Payable in Installments

An exchange of like-kind property is tax free unless boot is received. "Boot" may be cash or notes, or if you transfer property subject to a mortgage, the amount of the mortgage you give up is treated as boot, to the extent it exceeds any mortgage you assume on the property received; *see* ¶6.3. The boot is taxable, and if payable in installments, the following rules apply. Contract price is reduced by the fair market value of like-kind property received. Gross profit is reduced by gain not recognized. "Payment" does not include like-kind property.

The same treatment applies to certain tax-free reorganizations that are not treated as dividends, to exchanges of certain insurance policies, exchanges of the stock of the same corporation, and exchanges of United States obligations.

EXAMPLE

In 1996, property with an installment sale basis (basis *plus* selling expenses) of $400,000 is exchanged for like-kind property worth $200,000, plus installment obligations of $800,000, of which $100,000 is payable in 1997, plus interest. The balance of $700,000 plus interest will be paid in 1998. The contract price is $800,000 ($1 million selling price less $200,000 like-kind property received). The gross profit is $600,000 ($1 million less $400,000 installment sale basis). The gross profit ratio is 75% (gross profit of $600,000 ÷ contract price of $800,000). Like-kind property is not treated as a payment received in the year of sale, so no gain is reported in 1996. In 1997, gain of $75,000 will have to be reported (75% gross profit ratio × $100,000 payment), and in 1998 there will be a gain of $525,000 (75% of $700,000 payment).

¶5.35 "Interest" Tax on Sales over $150,000 plus $5 Million Debt

If deferred payments from installment sales of over $150,000 exceed $5 million, an interest charge is imposed on the tax-deferred amount. The special tax applies to sales of business or rental personal property as well as real estate for over $150,000.

Farm property and personal-use property, such as a residence, are exempt from the tax.

How to report interest tax. The interest charge is an additional tax. The method of computing the interest tax is complicated; the rules are in Internal Revenue Code Section 453A. In general, you compute the ratio of the face amount of outstanding installment obligations in excess of $5 million to the face amount of all outstanding installment obligations. This ratio is multiplied by the year-end unrecognized gain on the obligation, the top tax rate (Chapter 23), and also by the IRS interest rate for the last month of the year.

The interest tax is reported on Line 51 of Form 1040, the line for total tax. The tax is considered personal interest, and is not deductible; *see* Chapter 15.

Pledge rule for property sales over $150,000. If as security for a debt you pledge an installment obligation received on a sale of property exceeding $150,000 (other than farm property or personal-use property), the net proceeds of the secured debt are treated as a payment on the installment obligations, as discussed at ¶5.26.

Dealer sale of time shares and residential lots. The above interest tax and pledging rules do not apply to installment obligations from the sale of certain time-share rights (generally time shares of up to six weeks per year) or residential lots. However, under a separate rule, the seller must pay interest on tax deferred under the installment method; *see* the instructions to Schedule C of Form 1040 for reporting the interest charge as an additional tax.